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WILLIAMSBURG ECONOMIC SUMMIT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

FIRST SESSION

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WILLIAMSBURG ECONOMIC SUMMIT

TUESDAY, MAY 24, 1983

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room 2255, Rayburn House Office Building, Hon. Lee H. Hamilton (vice chairman of the committee) presiding.

Present: Representatives Hamilton, Hawkins, Scheuer, and Snowe.

Also present: James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Sandy Masur and Ruth Kurtz, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. The committee will come to order.

The Williamsburg economic summit, the ninth in a series of economic summits of the heads of state of seven major industrial countries begins in 3 days. A number of important and critical economic problems confront the seven leaders. Economic recovery in the United States is threatened by high real interest rates and looming budget deficits. Prospects for economic recovery in Europe are doubtful and recourse to protectionism is on the rise.

The dollar is overvalued. Serious exchange rate fluctuations threaten the stability of the international monetary system. Major debtor developing countries face serious social and political problems and instability as they try to adjust their economies to manage their debt burden, and the possibility exists that one or more of them may default.

Tensions also continue among the allies over the proper approach to East-West commercial relationships.

We've asked our distinguished panel this morning to give us their views as to what they think ought to be accomplished at the Williamsburg summit with respect to these problems. The witnesses include G. William Miller, former Secretary of the Treasury and Chairman of the Federal Reserve Board during the administration of President Carter; Robert Hormats, until recently Assistant Secretary of State for Economic Affairs; David Meiselman, professor of economics at the Virginia Polytechnic Institute, and a consultant on domestic and international monetary issues to the Reagan administration.

We're very pleased to have each of you here. I understand two of you have prepared statements; of course, they will be entered into the record in full. We will begin by having each one of you with prepared

statements summarize your statements, then let each of you make any additional oral statement, and completing that, we will turn to questions, by members, of each witness.

Mr. Miller, if you would please, we are delighted to have you here and we look forward to your comments this morning.

STATEMENT OF G. WILLIAM MILLER, CHAIRMAN, G. WILLIAM MILLER CO., WASHINGTON, D.C., AND FORMER SECRETARY OF THE TREASURY AND FORMER CHAIRMAN OF THE FEDERAL RESERVE BOARD

Mr. MILLER. Thank you very much, Mr. Vice Chairman. I appreciate this opportunity.

As we contemplate the forthcoming summit, I pause for a moment to confirm my belief that there is a sound basis for this kind of meeting among heads of governments or state. We live in a world which has become increasingly interdependent. I do not believe it is likely that we can succeed in either our domestic or our international objectives, economic or otherwise, if we maintain a provincial view of the world and deal only from a narrow domestic standpoint. We do need to coordinate our own economic program with the rest of the world.

Evidence of this interdependence is apparent when we realize that in 1960 perhaps 3 or 4 percent of our GNP was involved in international trade. By 1970 it was about 6 percent. Now it is 11 or 12 percent. Most Americans, thinking of Japan as a great trading nation, might be surprised to realize that the proportion of the Japanese economy devoted to international trade is not much larger than that of the U.S. economy.

One out of 3 acres of farmland in this country is devoted to growing crops for export. One out of five manufacturing jobs produce for export. So it's not likely that our economy can be vigorous and can meet our objectives unless we do take account of the growing degree of economic interdependence.

Along with that, of course, has come a complete change in the structure of international finance which has evidenced itself in a number of stresses over the past decade.

Nonetheless, the role of the economic summit has not yet evolved into a precise pattern. One of the roles of the summit should be to provide a forum for direct communication between heads of government. It is often said that we've had an explosion of knowledge in the postwar period. It would be helpful if we had not only an explosion of information and knowledge but an explosion of understanding. We benefit from direct communications where people are able better to appreciate the views, the cultural differences, and the goals of others.

The summit also would be an appropriate setting for establishing policy principles and objectives for international coordination. Direction can be provided by industrial country leaders for such coordination, working through other instrumentalities of government. We principals can also review, modify, or ratify policies or procedures that have been developed by subsidiary groups.

There are ancillary institutional forums that are needed to support the concept of the summit. Some of them are existing in institutions

like OECD, GATT, and the World Bank. Others have existed informally in terms of meetings of ministers of finance, foreign ministers, or trade ministers. All of those institutional forums need to be perfected, with improved coordination and integration.

Despite the overriding imperative today for international coordination, during the past few years the trend has been toward inward-looking policies. Despite the rhetoric of Williamsburg, one of the dangers is that underlying the summit will be a continued private emphasis on inward-looking, self-interest policies that do not accommodate the needs of the real world.

Inward-looking policies are understandable, even if they are dangerous and tragic. The 1970's produced oil shocks, inflation, the needs for dramatic adjustments, stresses on international finance, low growth rates, and high unemployment—reaching 30 million in the OECD countries, so it's understandable that governments through the political process have been encouraged by their constituencies to look inward at the very time when they should be looking at the broader world.

The inward-looking policies are evidenced by growing trends toward protectionism, in nontariff areas particularly, toward exchange rate policies that have caused difficulty in international trade and finance, and toward autonomous economic policies that have pulled the world apart instead of bringing it together.

With this brief background, I might comment for a moment on my views as to an appropriate agenda for Williamsburg.

It seems to me that the overriding objective—the priority at this time—for a summit should be to define policies that will produce vigorous, sustained, noninflationary economic growth for the entire world. The benefits of such a policy are legion. It would create stability, employment, and growth. It would resolve the international financial difficulties.

If we fail to restore economic growth, we will certainly encounter tremendous risks—social, political and security risks for the entire world.

As world leaders gather in Williamsburg, the U.S. economy is in a recovery mode. It is less apparent that there is recovery in other parts of the world, and the overriding question is, Can the U.S. economy itself sustain a recovery of adequate vigor and duration if there is not a recovery in the rest of the world? And can the U.S. economy sustain such a recovery if there is not renewed growth in international trade?

While subsidiary to this overriding priority, it is clear that the agenda will include the discussion of individual domestic economic policies and how these can relate to the common objective. The agenda certainly will include a discussion of the international financial and monetary situation—the debt problems of much of the developing world; the monetary structure with floating and widely fluctuating exchange rates. International trade will, of course, be an important subject—not only in relation to East-West matters, but, also on a broader array of issues.

The primary concern we are likely to find among the non-U.S. participants at the summit is the enormous U.S. deficits. The magnitude of these deficits is cause for considerable concern. It appears, if the

projected deficits persist, that 50 to 60 percent of all credit flows will be required to finance government spending. Put in other terms, if the deficits in the United States run at 6 percent of GNP and the private saving rate runs at 6 percent, then the Government will absorb all private savings and none of these savings will be available to finance growth of the private sector.

The President, not too long ago, gave a very dramatic illustration of how one could conceive of $1 trillion. The administration seems to be charting a course that will in 5 years—five of its own budgets—add a trillion dollars to our national debt. The increased interest costs from that additional debt will be greater than all of the nondefense, nonsocial security spending when this administration came to office. Obviously, the deficit problem is serious. The fear in the world is that high U.S. deficits will mean continued high real interest rates which will retard growth and keep the dollar high, thus burdening other countries in many ways; increasing the costs of their imports, augmenting their domestic inflation, increasing their debt and debt service costs, and contributing to capital outflows. Many nations fear that high real U.S. interest rates will dry up world trade and threaten the stability of the international financial system.

So the most important outcome of the summit could be an agreement in principle to pursue policies to reduce the U.S. deficit progressively on a credible basis over a relatively few number of years. I do not know whether such an agreement is likely. I do not know whether the administration is prepared to identify a path that would reduce the U.S. deficits over a reasonable period of time. It certainly would be an overwhelmingly favorable outcome if such an agreement could be devised.

In the area of international finance, the question of exchange rates will be an emotional issue. There are many reasons to believe that the correct way to deal with exchange rates and assure proper relationships among currencies is to pursue sound economic policies that will bring real interest rates to a lower level more consistent with historical experience. We're now, of course, experiencing the highest real rates in our history. If real interest rates could come down, then there might be a beneficial adjustment between the dollar and other convertible currencies.

In the absence of improved exchange rate alinements brought about by sound policies, there will be pressures to find some mechanism for attenuating the large swings in currency exchange rates that have been of so much concern.

As to East-West trade, it would be appropriate to consider whether many of the imposed or proposed restraints are effective in our own interest. Many such restraints may be more burdensome to us than on the East. However, it certainly would be in our interest to keep any East-West trade on a purely commercial basis, without government subsidies.

The summit is a major institutional development. The process has been evolving. It should evolve. It should become more flexible. It should avoid raising expectations that annual meetings can resolve each and every program. It should look to the longer term. It should seek to provide the mantle of leadership and principle essential to

assume economic well-being for the entire world. Widespread prosperity is the best guarantee of a peaceful world.

Thank you, Mr. Vice Chairman.

Representative HAMILTON. Thank you very much, Mr. Miller.

Mr. Meiselman, please proceed.

STATEMENT OF DAVID I. MEISELMAN, PROFESSOR OF ECONOMICS AND DIRECTOR, GRADUATE ECONOMICS PROGRAM IN NORTHERN VIRGINIA, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY, ANNANDALE, VA.

Mr. MEISELMAN. Thank you very much. I will summarize my prepared statement, and would like to offer it for the record.

Experience with almost a decade of economic summits suggests that, in general, we cannot expect significant changes in economic policy to follow such meetings. The advanced industrial countries participating in these annual events have close economic and political ties and there is, and would be, much ongoing communication among the attending countries and their leaders even if economic summit meetings never took place. Such was the case before summits began, and such would be the case if no further summits were held.

To be sure, periodic summits do force leaders to come together on a systematic basis and much planning and discussion takes place in preparation for these great events. Thus, there is some potential for facilitating an exchange of ideas, and perhaps for some very limited coordination of policies.

Along these lines, I would hope that the countries participating in the summit meeting will take effective action to lessen trade barriers, including those erected during the recent recession. Moreover, even if other countries do little to remove their own barriers, I would hope that the United States is wise enough to lower our barriers so that our own citizens can enjoy the benefits of less restricted trade and commerce. Among other things, lowering trade barriers is a sure and effective way to improve the economic situation and the debt repayment potential of the LDC's.

I would also hope that more effective policies with respect to East-West trade are adopted. At the very least, Western countries should not subsidize trade with the Communist bloc, nor tolerate the export of strategic goods.

The foreign exchange value of the dollar always seems to be a major topic at economic summits. This is understandable in view of the importance of international trade and the key role of the dollar. It seems only yesterday that the French were loudly bewailing the fact that, in their view, the dollar was too weak—not that the franc was too strong, and that the United States was exporting inflation. Now, the French and six other Socialist governments, ranging from Greece and Sweden to Senegal, complain of a strong dollar—not a weak franc, and call for intervention in foreign exchange markets to weaken the dollar, and perhaps also to move toward reinstituting large-scale intervention in foreign exchange markets, even a resurrection of the failed and defunct Bretton Woods fixed exchange rate system.

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To be sure, the dollar has been strong. Equivalently, the franc, the pound, and the mark have been weak. Also, the United States is running a current account deficit in its balance of payments, largely because the value of imports exceeds the value of exports. The balance of payments, I would remind you, is an accounting statement in which the net surplus on current account must equal the net deficit on capital account. Because the balance of payments, like other accounting statements, must balance, the current account deficit balances and is essentially identical to the capital account surplus. One result of the capital account surplus is that the U.S. interest rates are lower than they would otherwise be, which is most welcome. By the same token, the current account deficit also means that because we have more goods available in this country because imports exceed exports, it also means that U.S. inflation is lower than it would otherwise be. The result of a strong dollar is, therefore, lower interest rates and less inflation than would otherwise be the case. I believe that most Americans would count both of these as strong pluses. Intervention to weaken the dollar, for given foreign interest rates and prices, must lead to higher interest rates in the United States, more inflation, or both.

Moreover, a strong dollar is a spur to both export industries and import competing industries in foreign countries. This is why, especially during recessions, countries often try to depress their currencies in order to stimulate sales. Apparently, the French economy, with a very weak franc, is so mismanaged by their Socialist government that even a very weak franc hasn't helped them very much.

It seems to me that if the French wish to intervene in foreign exchange markets, they can certainly do so themselves with their own assets, as they have done in recent months. This way, French rather than U.S. taxpayers bear the exchange risks resulting from what is essentially government speculation in exchange markets.

By the same token, U.S. citizens who claim that the dollar is overvalued, in the sense that they believe that its foreign exchange value will fall sometime in the future, can readily put their own money where their judgments are and buy francs, marks, and so forth, or sell the dollar short. But why ask the U.S. taxpayers to fund or participate in these speculations?

Let us not confuse cause and effect. When countries pursue noninflationary and stable policies, exchange rates themselves are relatively stable. Little or no intervention is necessary to maintain the stable exchange rates. When, as in the 1960's, countries start to pursue inflationist policies and inflation rates then differ, no amount of intervention can save the fixed rate regime. Indeed, the same conclusion for the efficacy—rather, the lack of efficacy, of intervention was reached by the Working Group on Exchange Market Intervention established at the last summit of Versailles in their report of March 1983. The Working Group was composed of experts from the countries participating in the summit as well as representatives of the EEC and the Bank for International Settlements. If countries follow noninflationist, nondirigiste policies where persons and property are secure, intervention is not necessary to guarantee exchange rate stability. If countries inflate or create conditions that encourage the flight of capital, no fixed exchange regime can endure or has persisted without the control appa-

ratus of a police state. To pursue policies that result in inflation and capital flight, and then to blame the United States for a weak franc is surely an exercise in international scapegoating.

U.S. or IMF intervention in exchange markets would effectively underwrite inflationist policies abroad, including pursuing inflation creating policies in the United States. Under the usual arrangements, if there is U.S. intervention to support the franc, it will mean that the Federal Reserve increases the money supply to buy francs. But for given prices in the United States, there can be no permanent effect on the exchange rate unless French policy also changes, which is not at all assured. The one sure thing is that faster money growth in the United States will make it impossible to maintain the current state of slow or no inflation. Faster money growth in the United States will lead to more U.S. inflation, thereby following the French lead. This is a necessary and inevitable result of fixed rates and U.S. intervention to finance them. It may also be one reason why countries and special interests eager for inflation propose or cheer on such policies.

I'd like to make some brief comments and then I'll conclude on coordination. Discussions of coordination usually proceed on the basis of an underlying theory, typically never stated explicitly, that there is an effective tradeoff between fiscal policy, which has to do with changes in the aggregate of taxes, of government expenditure to affect the deficit, changes in the aggregate of fiscal policy and of monetary policy, that is the quantity of money; that you can jiggle with the aggregates and have a predictable certain effect on interest rates and perhaps on exchange rates.

In my judgment, the underlying theory, which is a Keynesian theory, is wrong. If you start out on the basis of an invalid theory, you can't get the results that you want.

In addition to that, for considering real interest rates, particularly in a floating rate world, U.S. real interest rates largely depend on U.S. policy. Interest rates in other countries largely depend on their domestic policy.

One of the functions of exchange rates and changes in exchange rates and the differential between spot and forward rate is precisely to take into account the change, through time, in response to interest rate differentials or changes in those differentials. It is only in a fixed rate world, I would remind you, that interest rates around the world tend to equality. If you have a fixed rate world, there is only one world capital market; there's one world money supply; and interest rates are the same and tend to equality around the world.

Under our present regime, we have no such thing, so that much of the discussion has to do with the world that died in the early 1970's with the demise of Bretton Woods.

I would also remind you that countries such as the United States that persist in heavily taxing saving and capital will have little of it, and thereby real interest rates must remain high whatever the shortrun fiddling of the aggregates of monetary and fiscal policy. Countries that print too much money will have inflation and high nominal interest rates, whatever happens to their fiscal policy aggregates or whatever other countries do or do not do with their own fiscal and monetary policy aggregates, particularly in a floating rate world.

In addition, the lags in the effects of these policies are so variable and so poorly understood there is little or no basis for believing that complex coordination among countries can work at all. Forecasts for individual countries, including our own, are surely full of error, unavoidable error given the current state of economics, so how can there be meaningful coordination among countries?

Moreover, since most proponents of some system of coordinating fiscal and monetary policies among countries wish to act on the basis of flawed economic theories, there is no way such efforts can ever work out as intended. In addition, the record is that despite hundreds of international meetings to discuss such coordination—usually held in some of the most pleasant settings in the world—there is precious little evidence of any successful implementation or results.

There is one more aspect of repeated calls for coordination that troubles me. Most of the other countries participating in the Williamsburg summit have parliamentary systems and cabinet government. They also have central banks which are effectively branches of their treasury departments. Only in America does the legislative branch have so much authority and responsibility for taxes and spending, and only in America is the central bank, the Federal Reserve, at least nominally independent of the executive branch of Government. This means that heads of state and government of other countries have a much wider range of options open to them and the commitments that it's possible for them to make in the operation of monetary and fiscal policies than is the case of our President. As a practical matter, then, I do not see many Members of the U.S. House or Senate who must vote on taxes and the budget bound by or even strongly influenced by any decisions made by foreign leaders about what U.S. taxes and budget deficits ought to be.

Finally, I believe that, in general, U.S. economic policies that result in economic growth and stable prices are not only best for our own people, they are also best for other countries, as well. This means policies of slow and steady money growth, continued deregulation, further tax reduction and tax reform to lessen the bias against saving and investment, and a reduction in bloated budgets. In the international area, this means removing barriers to trade, and exchange markets free of government fiddling and intervention.

To paraphrase Shakespeare, the fault, dear members of the Joint Economic Committee, is not in our trading partners but in ourselves that we have been in such bad economic shape. And I would hope that other participants in the Williamsburg summit come to the point where they admit the same for themselves and their policies.

Representative HAMILTON. Thank you, Mr. Meiselman.

[The prepared statement of Mr. Meiselman follows:]

Prepared Statement of David I. Meiselman

Experience with almost a decade of economic summits suggests that, in general, we cannot expect significant changes in economic policy to follow such meetings. The advanced industrial countries participating in these annual events have close economic and political ties, and there is, and would be, much ongoing communication among the attending countries and their leaders even if economic summit meetings never took place. Such was the case before summits began, and such would be the case if no further summits were held.

To be sure, periodic summits do force leaders to come together on a systematic basis and much planning and discussion takes place in preparation for the event. Thus, there is some potential for facilitating an exchange of ideas, and perhaps for some limited coordination of policies.

Along these lines, I would hope that the countries participating in the summit meeting will take effective action to lessen trade barriers, including those erected during the recent recession. Moreover, even if other countries do little to remove their own barriers, I would hope that the United States is wise enough to lower our barriers so that our own citizens can enjoy the benefits of less restricted trade and commerce. Among other things, lowering trade barriers is a sure and effective way to improve the economic situation and the debt repayment potential of the L.D.C.'s.

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I would also hope that more effective policies with respect to east-west trade are adopted. At the very least, western countries should not subsidize trade with the Communist bloc, nor tolerate the export of strategic goods.

The foreign exchange value of the dollar always seems to be a major topic at economic summits. This is understandable in view of the importance of international trade and the key role of the dollar. It seems only yesterday that the French were loudly bewailing the fact that, in their view, the dollar was too weak - not that the franc was too strong, and that the U.S. was exporting inflation. Now, the French and six other socialist governments ranging from Greece and Sweden to Senegal complain of a strong dollar - not a weak franc, and call for intervention in foreign exchange markets to weaken the dollar, and perhaps also to move toward reinstituting large scale intervention in foreign exchange markets, even a resurrection of the failed and defunct Bretton Woods fixed exchange rate system.

To be sure, the dollar has been strong. Equivalently, the franc, the pound and the mark have been weak. Also, the United States is running a current account deficit in its balance of payments, largely because the value of imports exceeds the value of exports. The balance of payments is an accounting statement in which the net surplus (deficit) on current account

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must equal the net deficit (surplus) on capital account. Because the balance of payments, like other accounting statements, must balance, (and because there has been essentially no U.S. government intervention) the current account deficit balances and is essentially identical to the capital account surplus. One result of the capital account surplus is that U.S. interest rates are lower than they would otherwise be, which is most welcome. By the same token, the current account deficit also means that U.S. inflation is lower than it would otherwise be. The result of a strong dollar is, therefore, lower interest rates and less inflation than would otherwise be the case. I believe that most Americans would count both of these as strong pluses. Intervention to weaken the dollar, for given foreign interest rates and prices, must lead to higher interest rates in the U.S., more inflation, or both.

Moreover, a strong dollar is a spur to both export industries and import competing industries in foreign countries. This is why, especially during recessions, countries often try to depress their currencies in order to stimulate sales. Apparently, the French economy is so mismanaged by their socialist government that even a very weak franc hasn't helped them very much.

It seems to me that if the French wish to intervene in foreign exchange markets they can certainly do so themselves

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with their own assets, as they have done in recent months. This way, French rather than U.S. taxpayers bear the exchange risks resulting from what is essentially government speculation in exchange markets. This illustrates the important point that any discussion of exchange intervention or fixed exchange rates is largely empty unless it includes the crucial details of which country or international authority has which rights and obligations.

Alternatively, U.S. intervention to buy francs requires that the U.S. also sells dollars to finance the purchase. Where can these dollars come from? First, we could finance the purchase of francs by increasing taxes or increasing the budget deficit. It seems to me that if there is merit to U.S. intervention, then there is also merit in the usual budgetary review and controls. Let Congress appropriate the funds, as in the case of most foreign aid, and let there be the necessary congressional review and authorization. Unfortunately, in the past virtually all such intervention has not only been off-budget, it has also been financed directly by the Federal Reserve's printing press. The dollars created to buy foreign exchange are added to the U.S. money supply, and they are thereby an additional source of inflation and ultimately of higher interest rates, as well. In addition, the U.S. taxpayers, not the French taxpayers, bear the exchange risk.

By the same token, U.S. citizens who claim that the dollar is overvalued, in the sense that they believe that its foreign exchange value will fall, can readily put their own money where their judgements are and buy francs, marks and so forth, or sell the dollar short. But why ask the U.S. taxpayers to fund or participate in these speculations?

This is why any scheme that includes intervention in foreign exchange markets means that there is much less control over the U.S. money supply. Indeed, a system of fixed exchange rates, such as the Bretton Woods system, means that the U.S. money supply becomes a by-product of U.S. intervention in foreign exchange markets, a mighty small tail to wag such a big dog.

I may add that, like other systems of government price fixing, the old Bretton Woods - I.M.F. system did not work and could not and did not endure, even in the period of far greater stability and far less inflation. In the process of breaking up in the late 1960's and early 1970's, the fixed rate system itself became an engine of inflation, as country after country intervened to buy one currency or another with its own printing press money. The result was that the whole world was flooded with excess money that was the major cause of inflation in the first half of the 1970's which dwarfed the inflation creating power of O.P.E.C. (See The Phenomenon of Worldwide Inflation, ed. David I. Meiselman and Arthur B. Laffer, 1975.)

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Let us not confuse cause and effect. When countries pursue non-inflationary and stable policies, exchange rates themselves are relatively stable. Little or no intervention is necessary to maintain the stable exchange rates. When, as in the 1960's, countries start to pursue inflationist policies and inflation rates differ, no amount of intervention can save the fixed rate regime. Indeed, the same conclusion for the efficacy - rather, lack of efficacy, of intervention was reached by the Working Group on Exchange Market Intervention established at the last Summit of Versailles in their report of March 1983. The Working Group was composed of experts from the countries participating in the Summit as well as representatives of the E.E.C. and the Bank for International Settlements. If countries follow non-inflationist, non-dirigiste policies where persons and property are secure, intervention is not necessary to guarantee exchange rate stability. If countries inflate or create conditions that encourage the flight of capital, no fixed exchange regime can endure or has persisted without the control apparatus of a police state. To pursue policies that result in inflation and capital flight, and then to blame the U.S. for a weak franc is surely an exercise in international scapegoating.

U.S. or I.M.F. intervention effectively underwrites inflationist policies abroad, including pursuing inflation creating policies here in the U.S. Under the usual arrangements, if there is U.S. intervention to support the franc, it will

mean that the Federal Reserve increases the money supply to buy francs. But for given prices in the United States, there can be no permanent effect on the exchange rate unless French policy also changes, which is not at all assured. The one sure thing is that faster money growth in the United States will make it impossible to maintain the current state of slow or no inflation. Faster money growth in the U.S. will lead to more U.S. inflation, thereby following the French lead. This is a necessary and inevitable result of fixed rates and U.S. intervention to finance them. It may also be one reason why countries and special interests eager for inflation propose or cheer on such policies.

The strong dollar is largely the consequence of the successful anti-inflation policy in the United States, the safe haven the United States affords foreign investors, and the improved prospects for substantial economic recovery. In my judgement, high interest rates are not the major factor causing the strong dollar. When U.S. interest rates fell sharply from July through November of 1982, the dollar continued to strengthen against the U.K. pound, the German mark, the French franc, the Japanese yen, the Italian lira and other major foreign currencies. If U.S. interest rates are crucial in determining foreign rates, why did the dollar strengthen, not weaken, when U.S. rates cascaded down?

Some of the discussion about possible coordination of policies among countries participating in the Williamsburg Summit focuses, not on important issues of lowering trade barriers and restricting the export of strategic goods to the Communist bloc - an area where coordination is both necessary and possible, but instead centers on the hoped for coordination among nations of domestic monetary and fiscal policies. The details of the coordination are derived from the application of a simple Keynesian economic theory that has been standard fare for some years, especially among economists over the age of 40 who are unaware that the underlying Keynesian theory is essentially empty. The theory deals with the economic aggregates of fiscal policy, government spending, tax receipts and the deficit plus the economic aggregates of monetary policy, the quantity of money. The rate of interest is seen as determined by the interaction between the size of budget deficits and the quantity of money; hence, the presumptions of a tradeoff between fiscal and monetary policy.

In the Keynesian analysis, interest rates are seen as the price of money. Deficits, easy fiscal policy, are interpreted as increasing the demand for money. The mechanism is the deficits increase aggregate demand. With more spending, people wish to hold more money to carry on day-to-day spending. For a given supply of money, which would be a tight monetary policy, higher deficits, by stimulating the economy, increase the demand

for money relative to the given supply, so interest rates rise. In this view, then, the mix of easy fiscal policy and tight monetary policy leads to higher interest rates, provided, of course, that the deficits stimulate the economy and lead to higher nominal G.N.P.

It follows that, according to Keynesian theory, in order to lower interest rates in one country, the rule is to reduce deficits and/or speed money growth. To coordinate the lowering of interest rates across countries, coordinate deficit reductions and faster money growth.

This theory is appealing, but wrong. If nothing else, interest rates are the price of time, not the cost of money. Interest rates cannot be lowered, except temporarily, by the use of the printing press. Indeed, we have learned from much sad and repeated experience that fast money growth leads to high, not low interest rates, and that slow, stable money growth is necessary for low interest rates.

With respect to fiscal policy, the main problem with this simple theory is that it simply doesn't work in practice. First, the complexity of budgets and taxes, and their impact on interest rates, cannot be understood by reference to the simple aggregate numbers used to describe budget aggregates and budget deficits, as is the current fashion. The inability of aggregate measures

to capture the impacts of taxes and government spending may also help to explain why the usual statistical data on government revenues, taxes and deficits have little or no historical relationship to inflation, interest rates, or G.N.P., evidence I presented to this Committee two years ago. (See, "Tax Cuts, Inflation and Interest Rates", Statement to the Joint Economic Committee, U.S. Congress, Hearings on Tax Policy: Are Tax Cuts Inflationary?, February 22, 1981.)

One reason one cannot generalize about the effects of budget deficits on interest rates, inflation, and resource allocation, is that so much depends on how the deficits are financed. Similarly, one cannot generalize about the consequences of eliminating deficits per se. It makes a difference whether government expenditures are reduced or taxes are increased. It also makes a difference which expenditures, and especially which taxes, are altered. Reducing the deficit by cutting government expenditures that have low productivity or subsidize consumption, in my judgement the bulk of the non-defense budget, would tend to lower interest rates and increase output and employment. Balancing the budget by increasing taxes that fall on investment and capital formation, by reducing returns to capital formation, and by reducing incentives to private borrowing to finance capital outlays may lead to a decline in interest rates, but at the heavy cost of impaired growth.

Thus, it does not even follow that reducing deficits necessarily leads to lower interest rates. That depends on which steps are taken to reduce spending or to increase revenues, not on the size of the deficit.

This is why I am so skeptical about stated concerns for the size of the deficit and the presumed links between deficits and interest rates that omit both reference to the specific measures to eliminate the deficits and to the required analysis of what these budget-balancing measures would do. There is even more uncertainty about evaluating the impacts of stated budget deficits because of the peculiar and arbitrary character of government accounting and budgeting procedures and the statistics the current budget process happens to generate. For example, including so-called "off budget" items involving large numbers of loan and guarantee programs would increase the numbers in the budget and the numbers called "deficit." Treating capital outlays for roads, buildings and the like in a separate capital budget, as private businesses do, with only "expenses" for depreciation and maintenance included in current expenditures, might well reduce the numbers in the budget and shrink the numbers labeled "deficit," but alter nothing of substance. Moreover, because even the best, most disinterested forecasts of budget deficits have almost always been very far off the mark, there is little basis for confidence in the reliability of either budget or deficit estimates. Future government

expenditures, revenues, and deficits depend on future inflation and economic circumstances that depend so heavily on future Federal Reserve policies. Future deficits also depend on actions of future Congresses, many members of which have not yet been elected to office.

In addition, the historical evidence also is that there is essentially no tradeoff between fiscal policy and monetary policy.

To avoid misunderstanding, when I state that jiggling with fiscal policy aggregates has little or no effect on short-run stabilization targets, I am not arguing that fiscal policy doesn't matter. Taxes, spending and deficits do matter and do have a great effect on resource allocation, economic efficiency, income distribution, jobs, economic growth and interest rates. Indeed, bloated budgets, high marginal taxes and the tax and expenditure system that is severely biased against saving, investment, working, innovation, risk taking and economic growth and instead is biased toward consumption and encourages battling over how to slice up the pie rather than making the pie bigger is bound to matter greatly precisely because the economic structure and economic results are profoundly altered. The resulting slow growth, high unemployment, high real interest rates and loss of competitiveness surely represent an impact of great magnitude and severity. To paraphrase President

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Kennedy, "A falling tide lowers all boats."

Countries such as the United States that persist in heavily taxing saving and capital will have little of it, and thereby real interest rates must remain high, whatever the short-run fiddling with the aggregates of fiscal and monetary policy. Countries that print too much money will have inflation and high nominal interest rates, whatever happens to their fiscal policy aggregates or whatever other countries do or do not do with their own fiscal and monetary policy aggregates, particularly in a floating rate world. In addition, the lags in the effects of these policies are so variable and so poorly understood, there is little or no basis for believing that complex coordination among countries can work at all. Forecasts for individual countries are surely full of error, unavoidable error given the current state of economics, so how can there be meaningful coordination among countries.

Moreover, since most proponents of some system of coordinating fiscal and monetary policies among countries wish to act on the basis of flawed economic theories, there is no way such efforts can ever work out as intended. In addition, the record is that despite hundreds of international meetings to discuss such coordination - usually held in some of the most pleasant settings, there is precious little evidence of any successful implementation or results.

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There is one more aspect of repeated calls for coordination that troubles me. Most of the other countries participating in the Williamsburg Summit have parliamentary systems and cabinet government. They also have central banks which are effectively branches of their treasury departments. Only in America does the Legislative Branch have so much authority and responsibility for taxes and spending, and only in America is the central bank, the Federal Reserve, at least nominally independent of the Executive Branch of government. This means that heads of state and government of other countries have a much wider range of options open to them in the operation of monetary and fiscal policies than is the case for our President. As a practical matter, then, I do not see many members of the U.S. House or Senate, who must vote on taxes and the budget, bound by or even strongly influenced by any decisions made by foreign leaders about what U.S. taxes and budget deficits ought to be.

Finally, I believe that, in general, U.S. economic policies that result in economic growth and stable prices are not only best for our own people, they are also best for other countries, as well. This means policies of slow and steady money growth, continued deregulation, further tax reduction and tax reform to lessen the bias against saving and investment, and a reduction in bloated budgets. In the international area, this means removing barriers to trade, and exchange markets free of government intervention.

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To paraphrase Shakespeare, the fault, dear members of the Joint Economic Committee, is not in our trading partners but in ourselves that we have been in such bad economic shape. And, I would hope that other participants in the Williamsburg Summit come to the point where they admit the same for themselves and their policies.

Representative HAMILTON. Mr. Hormats, please proceed.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, INTERNATIONAL CORPORATE FINANCE, GOLDMAN, SACHS & CO., AND DIRECTOR, GOLDMAN, SACHS INTERNATIONAL CORP., NEW YORK, N.Y., AND FORMER ASSISTANT SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. HORMATS. Thank you, Mr. Vice Chairman. I appreciate the opportunity to testify before this committee again on a familiar subject that we've covered several times before on earlier summits and I'd like to start out by sharing with this committee some thoughts on what summits can reasonably be expected to do and to reasonably be expected not to do—the benefits and risks of summits —to put them in perspective. We've had eight summits now and I think we have learned something from each of them.

What summits have been able to contribute over the last several years fall into several categories. First, summits have demonstrated their ability to espouse broad principles such as avoidance of protectionist measures. While these have not been foolproof, I think they have at least helped to avoid mutually destructive actions by governments, not entirely but to a degree.

Second, they've been able to develop certain objectives which governments have worked toward with a sense of mutual purpose; that is, such institutions as the World Bank and increasing support for the GATT trade negotiations in the Tokyo round.

The third area is that they have been able, under certain circumstances, to reach agreement on specific targets which can be monitored; for instance, the targets to reduce energy imports which were useful devices during the midst of the energy crisis in the latter part of the 1970's.

Fourth, they've been able to agree on studies which have shed more light on world issues and have helped leaders to resolve these issues subsequently with a greater degree of information and with less politicization of the problem.

Two examples that I would mention are the international nuclear fuel cycle evaluation—which was helpful in resolving an important conflict between the United States and Europe several years ago, and the Versailles study on exchange rates has shed additional light on that difficult and still very sensitive issue.

Summits also enable leaders to learn better one another's objectives, motivations, and interests, which is useful in helping individual leaders to plot their own priorities. They also enable leaders to develop their priorities within their own countries and collectively. That is to say, frequently leaders before summits get recommendations from virtually every agency of government, and leaders, when they get to the summit, have to determine what their priorities are, what the national priorities are among all these competing domestic priorities, and develop a certain sense of mutual or common priorities so that they can achieve certain agreed results at the summits.

Summits also make it more difficult for leaders to take actions which do violence to, or which are negative in terms of, the international

economy, knowing that they have every year to go back to the summit and to account to a degree to their peers for the actions they've taken. Now this is clearly not a foolproof process but it does create a certain additional consideration that leaders have to take into account when they shape policy.

There are, however, a number of risks, and we've seen those risks manifested rather clearly in the Versailles summit. The major risk, it seems to me, is that leaders attempt to use the summits to achieve too much. That is to say, they attempt to try to reconcile differences which are so deep or so deeply embedded in the political philosophies and national policies of various participants that raising them and pushing them very hard simply leads to friction. Another element of that is that, when they can't reach an agreement on substance, there tends to be an attempt to try to reach agreement on words in the communique. That leads to the sort of blowoff that we had after Versailles.

The leaders going into this summit have recognized these two problems. There is a genuine attempt, and I believe a very constructive attempt, to downplay still major differences on East-West issues. There is also, in my judgment, a very healthy attempt to downplay the communique which is to say not focus so much on words and focus more on substance.

There is, however, a risk in all this. The risk is that in attempting to bend over backward to prevent an excessively ambitious approach or trying to resolve differences that can't be resolved, leaders will make the other mistake of trying to do too little. And my concern about the lack of focus of the preparations of the summit and what I expect will be, from what all I hear, the relatively unfocused discussion could lead to, first of all, ambiguity in terms of results. That is to say, leaders come out of the summit thinking that different things were agreed to or each having his own or her own individual interpretation of what was agreed to; and second, a missed opportunity to forge agreements and to articulate those agreements in such a way that there can be followup by ministers and officials in a mutually supportive way.

And my worry about Williamsburg is that, in an attempt to avoid the mistakes of Versailles—an appropriate attempt to avoid the mistakes of Versailles—it will simply not provide the leadership, not provide the sense of purpose, the sense of direction which I believe people are looking for at that summit.

I won't go over all the points of substance because previous speakers have discussed those. I must say I find myself very much in agreement with the sorts of priorities that Bill Miller outlined for the summit. In particular the question of the U.S. deficit is going to be on everyone's mind because it does have an effect on interest rates, on the rate of growth in the American economy, on the pressures in this country for protectionism. Many of those pressures stem from an overvalued dollar which has reduced the competitiveness of a lot of American industry and agriculture. Much depends on what happens to the U.S. budget deficit, but that's not the only thing.

One can't simply say—and I think that Bill has indicated that as well—that that's the only issue. There are a lot of others, and he pointed them out very well.

It strikes me that we are caught today in what one might call a triangle of international economic instability. You have three sides to

the triangle. One, slow growth and high unemployment; the second side is debt-related constraints on growth in the Third World; and the third side are pressure on the trading system. And it strikes me that if Williamsburg has a historic purpose, it is to try to develop a strategy for dealing with these interrelated problems.

Now there are no miracles. There are no panaceas, and Williamsburg is certainly not going to be a panacea, but it can help by developing a strategy to avoid the sort of defensive ad hoc approach which has been taken on a number of these issues so far.

It seems to me that first they can agree on a set of mutually reinforceable economic measures. Included among those is an attempt by the United States to reduce its deficit, which would help other countries to in turn relax their own monetary policy. And it strikes me that even if you take a lot of these measures, even if the measures are modest, they further will broaden and I think strengthen the recovery.

Second, the summit is going to have to address the problem of unemployment because even if there is a recovery, unemployment is still going to be a major problem in the industrialized democracies. Much of it is structural. A lot of it in the United States is youth unemployment, but there is also a growing number of people in their middle years, 40 to 55, who find themselves displaced by technological change and by reduction in capacity in traditional industries. The summit, again, is not going to come up with miracles, but it must, in my judgment, focus on that issue and try to establish a process, which I've discussed in greater detail in my written testimony, to deal with this issue.

Debt problems I think must be addressed, as Bill indicated, and it strikes me that several things need to be done. One, to press for prompt implementation and ratification of IMF quotas that were agreed to and an increase in the GAB, support for increased structural assistance, including a speedup of World Bank lending to help countries to adjust.

Also needed are longer term and lower cost rescheduling agreements so that countries can have adequate breathing space to help strengthen their economies, and sustained commercial bank lending.

I also think that summit leaders themselves should make an attempt to strengthen public understanding of the need to increase development assistance, particularly assistance to the poorer countries.

I would simply make one general statement. That is, prolonged austerity in developing countries is not the same as prolonged austerity in the developed countries. My worry is is that if this situation continues, the difficult straits these countries find themselves in today are going to lead to increased social pressure and political pressures on them which may weaken the very government in the stabilization plans.

With respect to the medium term, it strikes me the summit should welcome the decision of a couple of weeks ago, to expand the Group of Ten and to use it for closer and more systematic consultation among trade and finance officials to avoid trade impediments which worsen the financial situation.

I think the Group of Ten could also be given a mandate to look at exchange rate instability and misalinements which distort trade and investment. I discuss this more in my prepared statement so I won't go into it now in detail.

I also think that they should use this summit as an attempt to establish an additional momentum—or shall we say regain the momentum—toward improving the trading system. That is to say, avoiding new barriers and new subsidies and making a genuine attempt to take the initiative to reduce those which currently exist and to get the rules of the trading system improved.

These are the general points I wanted to cover in summary and I'd be glad to answer any questions.

[The prepared statement of Mr. Hormats follows:]

Prepared Statement of Robert D. Hormats

I appreciate the opportunity to testify at this hearing on the Williamsburg Summit. As a member of planning teams for, and of the U.S. delegations to, the last eight Western economic summits, I have closely followed the evolution of the Summit process from its beginnings at Rambonillet — in the aftermath of the first oil crisis — up to the present. As I shall discuss in this testimony, I am concerned with the way the process has evolved — from a mutual effort to develop a sense of common purpose among Western leaders about how to strengthen the world economy to a highly publicized contest of political wills. Because of the important role summits have played, and can play in the future, in strengthening the world economy — and thus that of the U.S. and all other nations — I profoundly hope that the leaders meeting in Williamsburg will put the summit process back on a constructive track.

The international economy today — despite the beginning of American economic recovery and decline in inflation, oil prices and interest rates — remains in a precarious state. At no time in the post-World War II period has there been a greater threat to its cohesion and to the fundamental principles of cooperation on which it is based. The human tragedy of nearly thirty-five million people unemployed in the industrialized democracies and tragic setbacks to the prospects of virtually all developing nations attest to the seriousness of the situation. Without significant improvements, we are likely to face a major deterioration in the world economy — which would add to the economic problems of many countries, including the United States, and undermine political and social stability in many parts of the world.

The Williamsburg Summit will test the ability and commitment of the major economic powers to substantially and concretely improve the world economy.

It will be especially important to overcome the tendency — exhibited so often of late — to react defensively to events and pressures rather than pursue a forward-looking strategy. If, after World War II the Marshalls, Spaaks, Bevans and Monets had taken an inward-looking approach, that period would almost certainly have been one of great turbulence, and the major international institutions so essential in promoting recovery and prosperity would not have been created. But in spite of the enormous difficulties their countries faced, or perhaps because of them, these statesmen forged a forward, and outward, looking strategy. Their commitment to the creation of the architecture of improved international monetary and trade cooperation was based on a recognition that the inter-war experience, with its barriers to commerce and capital, was both politically and economically harmful, and that no country could ensure its economic or political wellbeing without a substantial measure of common effort to make the world economy work effectively. A similar attitude, and equally bold leadership, are no less important today in order to reverse the creeping deterioration and defensiveness which have come to be mutually reinforcing.

The American economy, with over 12% of its GNP accounted for by exports, with its banks heavily exposed abroad, and with a still major dependence on imported oil and raw materials, can ill afford a deterioration of the international economic system. When the U.S. first assumed international economic leadership after World War II, it was because promotion of a well-functioning and prosperous world economy was a necessary part of America's leadership of the free world. U.S. political and security interests demanded it. That remains no less true today. But today, in addition, U.S. economic interests — jobs, domestic growth, the well-being of U.S. agriculture and many U.S. manufacturing industries and the stability of our financial system — demand it. There is no better place for an American president to demonstrate that

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leadership than at an economic summit. The timing of Williamsburg — at a time of serious pressures on the international economic system — presents a splendid opportunity.

In my judgement, the central themes at Williamsburg should be: to promote policies leading to sustained increases in growth and employment, help developing countries to successfully cope with the debt problem without sharp reductions in their economic growths and relieve major stresses on the international trading system. Low growth, high debt and trade problems form three sides of the triangle of instability in which the world economy is caught. Each feeds on the other, and thus all must be dealt with. If the Williamsburg Summit has an historic contribution to make it is in devising a strategy by which the major economies can approach the resolution of these problems with a sense of common purpose.

Such a strategy should include a set of mutually supportive measures by developed and developing nations taking full advantage of the strengths of the major international institutions. No single meeting, such as a new Bretton Woods, is likely to bring about the progress needed. Nor can the United States, or any other individual nation, alone provide enough "locomotive thrust" to lead the way to international recovery. What is necessary is a set of soundly conceived steps in national capitals, and in the IMF, GATT, World Bank and OECD. Moreover, problems which have been years in the making will not be resolved immediately. Therefore, any strategy must have short, medium and long term components — including certain measures which need to be taken right away and others, to address structural and institutional difficulties, which will take more time.

First, a concerted effort by the large industrialized democracies should be agreed on at the Summit to promote sustained recovery in ways which do not run a high risk of increasing inflation or interest rates. A number of mutually reinforcing economic measures, even if some are individually modest, can taken together strengthen and broaden international economic recovery. A similarly concerted effort by industrialized

nations — centered in the OECD — is needed to identify from their collective experience, and expeditiously implement, programs which have demonstrated success in reducing unemployment, particularly structural and youth unemployment.

Agreement is also needed on a multi-faceted effort to help developing countries overcome debt problems without an abrupt decline in their economic growth. This would include: prompt ratification of recently agreed IMF quota increases; support for increased structural adjustment assistance to help countries to improve the capacity to manage their debts; longer term and lower-cost rescheduling agreements which provide countries with adequate breathing space to strengthen their economies and sustained financial flows to facilitate adjustment. Together these would enable, and encourage, developing countries to improve their debt situations without a sharp reduction in growth or harmful import restrictions. This should be coupled with a commitment of Summit leaders themselves to strengthen public understanding of the need to increase development assistance, particularly to the poorer nations (with stress on meeting existing pledges to, and suppporting future increases in, the resources of IDA) and an effort to find ways to help countries suffering from the volatility of commodity export earnings.

With respect to the medium term, the Summit should both welcome the recent decision to use the enlarged Group of Ten for closer and more systematic consultation among financial and trade officials in order to avoid trade impediments which complicate the debt problem, and ask it also to focus on ways of avoiding exchange rate misalignments and volatility, which also tend to distort trade flows and investment. And, in light of the favorable outlook for economic recovery, leaders should commit themselves to a moratorium on new or increased trade barriers and subsidies, coupled with a renewed effort to develop a consensus in favor of, and to expeditiously pursue work programs to achieve, major improvements in the rules and dispute settlement procedures of the GATT.

Finally, the leaders should address the institutional problems facing the world economy and ask their advisors, before the next Summit, to recommend ways to overcome such problems — with special emphasis on possible institutional changes to deal with the relationships among growth, trade and monetary issues and to broaden mutually beneficial ties between industrialized and developing nations.

I shall expand upon these after a brief discussion of the problems we currently face.

Relationships Among Current Problems

The world economy is beset by a convergence of three negative forces. Or, to put it another way, it is caught in the midst of a triangle of economic instability. The three sides of the triangle, are: (1) prolonged recession and high unemployment; (2) debt-caused constraints on developing countries' growth; and (3) serious pressures on the trading system. Each in part results from, and contributes to, the others.

The deep and prolonged recession, and high unemployment, in industrialized countries has increased sensitivity to foreign competition, and induced government intervention both to limit imports and increase exports, as countries try to sell similar goods in a shrinking world market. It has also slowed exports of developing countries, and weakened prices for their commodities, thus reducing their ability to earn the foreign exchange needed to repay their debts. High interest rates have added considerably to the debt problem and reduced the ability of countries to adjust to changes in the world economy. Trade protection and subsidies, in part a product of the recession, have combined to reduce growth and raise costs, while further complicating the financial situation by limiting some countries' export earnings and thus their debt repayment capabilities. And financial constraints on the ability of developing countries to borrow have curbed their growth and thus exports of industrialized countries — making their recovery more difficult. Exchange rate instability and misalignments have distorted

trade, generated demand for subsidies and protection, and caused uncertainties which have weakened investment.

Resolving these problems requires an intensive focus on interrelationships for which the institutional structures of today are poorly suited. During the last three decades, the economies of the world have become highly integrated. Developments in domestic economies have become intertwined with those of the international financial and trading system. But, for the most part domestic and international economic policies and institutions have not adequately reflected these interrelationships. International trade issues, financial matters, and questions of domestic economic growth and employment are generally addressed separately, with little understanding of, or attention to, the implications of actions in one area on the others.

Turning first to domestic policy, the accepted, and indeed generally the logical, answer to high inflation is to tighten up on monetary or fiscal policy, or both, in order to reduce domestic demand. But if many countries do this simultaneously — as in recent years — the result will be a mutually reinforcing, and therefore in each country greater than anticipated, decline in growth. Indeed the fact that so many industrialized countries in the last few years have had to take tough anti-inflation measures at the same time — in part to compensate for postponing adequate anti-inflation measures earlier in the 1970-s — has caused the recession in each to be deeper, and longer, than had only a few countries taken such measures.

Secondly, many of the largest developing countries — which, lest it be forgotten, were in fact the locomotives of world growth in much of the 1970's — now face constraints on growth and imports as a result of weak demand for their exports, low commodity prices, high debts, and difficulties in securing new loans. In order to reduce their debts, many are taking measures to limit consumption in order to curtail imports, and to boost exports. While this may succeed in individual cases, progress will be frustratingly slow if many developing countries try to do this on a large scale and all

at once, while many industrialized nations at the same time are trying to increase exports and restrict imports. Such a situation is also bound to result in a very high level of trade friction, as each country tries to counter the actions of others. Everyone cannot, clearly, increase exports and reduce imports at the same time.

But if significant improvements in developing country trade balances are not quickly attainable in this environment, can such countries obtain financing needed to enable them to manage their debt and undertake necessary adjustments without a dramatic reduction in growth? And if they cannot, what are the implications are for these nations, and for their trading partners? Of the sources of financing available, concessional development assistance has been limited by budgetary constraints in many donor nations at precisely the time when such assistance is especially vital for developing countries, and a necessary investment in the long term health of the world economy. Commercial banks are cautious because of a generalized desire to reduce risk, concern over potential actions of regulatory authorities, reluctance of regional banks to participate in syndications, and weakness in domestic loan portfolios.

This puts a particular responsibility on the IMF. It is being called on to provide transitional financing in order to avoid a sharp reduction in economic activity in debtor countries while they are attempting to work down their debt to more manageable levels. The IMF, in such circumstances, is faced with the need to carefully balance what is necessary to achieve steady improvements in a country's debt situation against the risk that its recommendations, if too stringent, will undermine the country's political cohesion or its government, and thus its ability to take any firm economic action at all.

The economic, political and human impact of a sustained period of negative or very low growth in most developing countries is far more serious than in industrialized countries. In contrast to industrialized nations (which have deeply rooted political systems, low population growth, and relatively generous social security and unemployment benefits), most developing countries have an only recently established political system,

high population growth, and very little in the way of unemployment or social security programs. Thus their tolerance for prolonged austerity is relatively low. Indeed there is a grave risk that abrupt or sustained declines in growth may weaken the very government being asked to undertake the stabilization program.

Further complicating the Fund's dilemma is that it has traditionally prescribed policies which reduce consumption and imports, and increase exports, in an international environment in which other economies were growing enough not to mind taking more of the exports of the debtor or selling less to it for a time. In the current environment of simultaneous recession, that is not the case.

While not at the moment as urgent as the debt problem, exchange rate volatility and misalignments have also had an adverse impact on trade and growth. In earlier years trade balances were a major factor, if not the major factor, influencing exchange rate movements. A large trade deficit normally caused a nation's currency to depreciate; a large surplus caused it to apreciate. Thus movements in exchange rates normally led to reduced trade imbalances: weaker currencies normally made domestic goods more internationally competitive; stronger currencies made them less. Today, the impact of capital movements — which often amount to several billions of dollars a day — on exchange rates dwarfs that of trade balances. Capital movements respond to such factors as differential interest rates, inflationary expectations, monetary/fiscal policy mixes and political/security factors. Differences in monetary/fiscal policy mixes, for example, can lead exchange rates to move in directions opposite from what is required to narrow trade imbalances; when they do so, pressures are generated for protection or subsidies to offset the competitive disadvantage resulting from the disparity. Sharp capital flows can also force countries to defend exchange rates with measures which complicate domestic economic policy management.

The larger the portion of a country's economic activity affected by international trade and finance, the greater the impact on it of exchange rate movements. Thus

smaller trading countries are particularly sensitive. But the U.S. is far from immune. The appreciation of the dollar in the last two years contributed both to a lower rate of U.S. inflation and to a deep recession. A depreciating dollar will, on the other hand, likely contribute to U.S. recovery but an excessive drop could also add to inflationary pressures.

Underlining these problems, and complicating solutions, are structural and institutional difficulties.

Over the last two decades, a number of countries have imposed on their economies myriad regulations, allowed expenditures to increase at a rate substantially greater than GNP, and significantly augmented domestic subsidies. While many such measures may have been justifiable on their individual merits, they collectively created structural rigidities which increased costs and slowed growth in the capacity to export more and better compete with imports. They made it particularly difficult for some economies to adjust to, or take advantage of: new technologies, the growth of developing countries as competitors and markets, and sharp changes in the price of oil. And inflation and high interest rates, followed by deep recession, have chocked off the very investment needed to overcome many of these rigidities.

A discussion of institutional weaknesses completes the picture. In the 1970's, despite major foreign exchange crises, dramatic increases in the price of energy, and serious inflation and recession, countries generally avoided beggar-thy-neighbor policies. They recognized that irresponsible actions would weaken the international economic system to their ultimate disadvantage. The IMF, World Bank, GATT, OECD and Economic Summits helped to resolve problems, limit damage, and make progress in such areas as trade, energy and development assistance.

Today's problems are generating a more defensive attitude and reducing support for multilateral institutions and solutions. This is particularly unfortunate at a time when economic interdependence has reduced the ability of nations to resolve problems

by themselves. Moreover, the very active role being played by developing countries in the international economy — and the less dominant role of the U.S. and other industrialized nations — makes a broadening of international cooperation essential.

As world trade has slowed, and unemployment increased, the trend towards trade liberalization — which enjoyed popular support in better times — has been reversed by a series of bilateral restraint arrangements, proliferating non-tariff barriers, new requirements that foreign investors use a certain percentage of locally produced goods or artificially boost exports, and increased use of trade distorting subsidies. Such measures generally have bypassed the GATT — because its rules either did not limit the particular practice or were ambiguous enough to be discounted. Extra-GATT solutions, and GATT's difficulties in expeditiously resolving problems, have weakened that institution. More serious, however, is the inadequate support it receives from many members, who prefer to avoid the constraints its rules place on their actions and fail to make adequate efforts to strengthen it.

Likewise, major developments in the international financial arena in the 1970's tended to circumvent the IMF. Borrowing by many developing and Eastern European countries in the mid and late 1970's financed new investment and offset sizeable trade deficits. Such borrowing helped to sustain the growth and development of a number of countries and held up the level of demand for industrial country exports, thereby reducing the severity of recession in the OECD area. But it also led to burdensome debt obligations and permitted some borrowers to put off instituting policies to curb import demand or shift resources to more competitive uses. And, as private lenders played a larger role in balance of payments financing, the role of the IMF, as an institution which encourages and supports stabilization policies, became less central.

Finally, the OECD and Economic Summits have not been well utilized of late by member governments to resolve key issues. And a defensive "how-can-we-get-others-to-go-along-with-our-position-while-not-accepting-theirs" attitude has replaced the

"what-can-we-do-together-to-improve-the-world-economy" approach which Summits were intended to foster.

Goals for the Summit

Growth and Jobs

The single most important thing that the Summit can do — building on the agreement reached two weeks ago at the OECD Ministerial — is to forge a broad agreement on a number of mutually reinforcing measures to achieve sustained increases in growth and employment without rekindling inflation and high interest rates. Progress in these areas will not completely solve international financial and trade problems — some of which are structural — but it would be a powerful positive step. A key requirement is a common effort by those countries in a position to do so to adjust policies to achieve or sustain higher rates of growth. For the U.S. this means continuation of current flexible Federal Reserve Board policies and a reduction in the large budget deficits projected for 1984 and 1985. This would stimulate additional U.S. domestic investment by lowering interest rates, and significantly improve growth and international debt management prospects. It would also reduce the exchange rate of the dollar, which would both improve American competitiveness (thus reducing pressure for protection or subsidies) and enable some other countries to relax their monetary policies without running the risk of a major outflow of capital or a weakening of their currencies.

Each country will have to decide for itself how much flexibility it has. But a common commitment of Summit countries to take advantage of existing flexibility can make expansionary policies easier to sell domestically, particularly because countries reluctant to unilaterally stimulate their economies because of the prospect of a weakening of their balance of trade run a much smaller risk of this occuring if several act together. Countries with low rates of inflation will have, in this respect, greater room for maneuver than those which do not, who may in fact need to tighten up. Countries with a high ratio of savings to GNP, or budget deficits due largely to slow

growth rather than to structural imbalances between revenues and expenditures, will likely have more latitude for running stimulative deficits than those with lower savings-to-GNP ratos or a large structural budget gap. Some countries, in this context, may see an opportunity to reduce certain structural impediments to growth by, for instance, reducing wage indexation or regulations which discourage investment. Others, as noted, may be able to exercise greater monetary flexibility. The point is that just as the simultaneous contraction in demand in the industrialized democracies — by reinforcing one another — led to an unanticipated severe decline in their collective growth, so combined growth-oriented measures, even if individually modest, can — also by reinforcing one another — lead to a stronger and broader recovery.

The need to create jobs is particularly urgent. Unemployment today is a massive human tragedy. It also undermines confidence in market economies and, in some areas of the world, in the democratic systems which maintain them. In certain countries it threatens the very continuation of the democratic process itself. The problem is especially serious because the anticipated economic recovery is unlikely to significantly reduce unemployment in many important sectors. First, if private employers believe that recovery will be short-lived, they will be disinclined to add many new employees early in the upturn. Second, and more fundamentally, there has been a major reduction in capacity in some important traditional industries; e.g. steel, autos, shoes and textiles. And the application of new labor-saving technologies in these and other sectors will reduce the number of workers required to produce a unit of output. In some cases new technologies, by boosting overall productivity, will rejuvenate declining firms; to the extent firms are preserved in business thereby, this could mean more jobs than had the new technology not been installed at all. But the net effect will, in any case, be fewer jobs in sectors which in the past accounted for substantial employment. And while many new jobs will be created in high technology sectors, their number, at least in the near term, is unlikely to exceed that lost by capacity reductions and new

technologies in traditional sectors. Moreover, even accepting optimistic assumptions about the number of new high technology jobs, many workers displaced from older sectors are unlikely to be able to move into them.

The U.S. and most other industrialized democracies will have to deal with two basic types of structural unemployment: unemployed youth who have difficulty obtaining entry-level jobs and are often laid off first during slow periods, and older workers displaced by capacity reductions and technology shifts. Large government sponsored training programs — particularly in an era of rapid technological change — will probably be needed, as will hiring incentives for the private sector and large-scale productive infrastructure programs (which have the triple advantage of meeting a major national need, creating constructive jobs, and eliminating bottlenecks which would add to inflation when growth resumes). The Summit could usefully ask labor and finance ministers, taking advantage of work already done by the OECD in this area, to determine what types of programs have succeeded, what types have failed, and why. Commitments could also be made to expeditiously implement programs which have demonstrated their effectiveness.

Financial and Monetary Issues

There are several steps which the Summit could constructively take to bring about improvements in the international financial and monetary areas.

There has been, since the fall of 1982, a greater sense of unity and common purpose among the major industrial democracies in finding a constructive solution to the debt problem than on any other international economic issue in recent memory. This attests both to its seriousness and to its potential impact on all economies. But despite recent supportive measures, it is quite possible that we are only in the eye of the hurricane. Much of the debt is still short-term, and repayments have only been pulled back for a time. The problem requires additional attention and the developing countries require additional support.

Because of the magnitudes of some debt problems, a credible program to strengthen a country's balance of payments position may require an unusually long period of time and substantial transitional financing. I stress the word transitional because the debt problem is both a liquidity and a structural problem. Countries thus require balance of payments support as they seek to narrow the gap between debt levels and servicing capability, and they need assistance as they work to improve the structure of their economies in order to, for instance, shift away from import substitution policies or try to lessen dependence on imported oil. And, they need help to ease the social pains of adjustment, particularly on lower income groups. For such countries the real question is not whether to adjust but how — how fast, how to ease the attendant social and political strains, and how to validate the adjustment by generating the necessary new investment to improve the productive capacity of their economies.

While countries facing such situations recognize that the primary responsibility for addressing their debt problem rests on their shoulders, they also need and expect assistance by the international community — and the adverse international implications of the debt problem gives the international community a strong reason to respond constructively. In the period ahead several steps — which could be agreed on at the Summit — will be necessary.

- prompt ratification of recently agreed IMF quota increases and increases in the General Agreement to Borrow;
- assistance to the IMF effort to borrow should it need to do so to maintain or augment its liquidity;
- willingness of governments to undertake large-scale bridge financing where necessary;
- increased structural adjustment assistance, through both bilateral and multilateral channels, to support the necessary adjustment or improvement of capacity;

- support for longer-term debt rescheduling agreements which are tailored to likely repayment capabilities, and linked to IMF standby-agreements, and which therefore involve less of a "risk premium".
- an urgent dialogue between industrialized and developing nations in order to reduce the barriers to trade which have complicated the debt problem.

Another improvement which the Summit could address would be an enhanced and more systematic consultative, or surveillance, process among financial authorities in the larger countries — including trade ministers. The expanded Group of Ten could be asked to perform this function. It has been about ten years since floating rates went into effect, and we have learned a few lessons. While far preferable to the rigid system of Bretton Woods which, lest it be forgotten, led at the end to major misalignments and frequent currency crises, floating rates have not always promoted the smooth adjustment among currencies that was originally envisaged. In some instances they too have resulted in exchange rate misalignments which distort trade and investment, and thus generate domestic pressures for offsetting trade actions. In some cases misalignments has resulted from conscious decisions of a governments to devalue in order to reduce imports and increase exports; in others, they have arisen from differential interest rates, or market perceptions about future rates of inflation or political stability.

In some periods what one country views as an adverse exchange rate is quite satisfactory to another; but there are times when prudent judgement — and obvious distortions in trade flows — suggest that misalignments have occurred. While exchange rate considerations normally should not dominate domestic policy, there are times when a domestic economy is harmed by a particular exchange rate, or misalignment is so apparent, that remedial action is necessary. There are also times when, however strongly people may believe the market will correct imbalances, political forces will not allow the market sufficient time to do so, and will insist on protective measures

or subsidies to offset exchange rate caused imbalances. This would institutionalize another kind of distortion, which would presumably be more objectionable to those who have faith in the market than temporary exchange rate intervention or other measures to correct exchange rate misalignments.

Recognizing this, more systematic consultation is desirable to (a) identify "danger zones" for major currencies, i.e. zones which indicate when currency relationships are so out of line that they are likely to result in major economic and trade distortions; (b) determine, when currencies enter such zones, why this is occurring; (c) consider what corrective actions are most appropriate; (d) discourage competitive exchange rate devaluations. In some cases the needed corrections may require changes in the monetary/fiscal mix. In others intervention in exchange markets may be needed. While the latter is unlikely to lead to major changes in exchange rates when domestic rates of inflation, real rates of interest or other fundamental economic factors diverge substantially, there are times when foreign exchange markets are dominated by short term, often psychological, factors. And, on occasion, national monetary authorities inadvertently exacerbate the problem. To the extent that monetary authorities agree to resist excessive volatility or divergencies, major private traders would themselves be less inclined to make decisions based on short-term factors and improper manipulation of rates could be prevented.

An integral part of the international financial outlook is the outlook for development assistance. While it is understandably tempting for legislatures and budget makers to cut foreign assistance budgets during times of domestic austerity, there is also a cost to this. Development assistance is critically important to a number of countries to help them maintain even minimal rates of economic growth and necessary improvements in human well being. Moreover, in many developing countries the capacity to repay debt will depend on structural changes, such as improving their agricultural systems and generating additional energy production. Many cannot make such changes

without outside assistance. And the World Bank, as well as the Asian, African, and Inter-American development banks, have greater influence in encouraging sound economic policy in recipient countries — including avoidance of the use of trade barriers — if their advice is backed up by financial resources which can support those countries' development plans.

IDA is particularly important. Its funds go to the poorest countries, many of which, even in the best of times, have little or no access to commercial funds. The World Bank and other institutions can help by speeding up the flow of financing to developing nations, and allowing a larger portion of their overall program to be used for structural adjustment and balance of payments assistance (to permit the purchase of spare parts and raw materials, the lack of which hampers production) where such financing is related to sound adjustment programs.

There also needs to be a rethinking of how to avoid excessive volatility in earnings from commodity exports. Sharply depressed commodity revenues have disrupted development planning for many countries, and, in turn, adversely affected the economies of countries which export to them. In the longer run, low prices will reduce investment in new production capacity, thereby increasing the potential for sharp price increases when demand picks up. There has been much discussion of, and controversy about, this subject in the past. A re-examination of the problem in light of the experience of the last few years might lead to a better understanding of the benefits and limits of commodity agreements, how countries might go about the development of sound agreements, and whether a global STABEX, or improvements in the IMF's Compensatory Financing facility, might be desirable.

Trade Issues

The recent GATT Ministerial Meeting correctly stressed the degree to which the international trading and financial systems are closely intertwined with one another, and with domestic economies. The fact that the GATT Ministerial meeting in November

failed to live up to expectations raises the risk of a series of unilateral and bilateral trade actions. But it may also have shown a number of people the "sight of the gallows" into which, due to the lack of effort by certain countries to improve it, the neck of the trading system is being inexorably placed. The meeting several months ago between senior U.S. cabinet members and senior EC commissioners, and steps announced by Japan's new Prime Minister, Mr. Nakasone, give some hope that a more purposeful attitude will be evidenced in the future.

But it is particularly alarming in that, unlike the period in which the last GATT Ministerial took place ten years ago, there is virtually no international concensus today as to how to improve the trading system, what should be negotiated, or even whether any negotiations should take place. Nations tend to look inward in difficult times rather than focus on systemic improvements.

What therefore appears necessary is: (a) a Summit commitment to a moratorium on new trade barriers and subsidies; (b) a similar commitment, broadened to include developing countries as well, to expeditiously pursue in the GATT a series of work programs to improve understanding of the nature and dimensions of problems in such areas as agriculture, services, and investment, to determine how they can be better managed under existing GATT rules, and to decide whether, and how, more formal negotiations should be instituted; (c) an urgent effort to improve GATT's dispute settlement mechanism, and (d) agreement on a safeguard system supported by industrialized and developing nations and on a way to gradually bring under the GATT the various trade measures which have been taken outside of its framework.

The reality is that in many sectors today free trade is more a myth than a reality. Over half of world trade today is subject to some type of government support or intervention; that figure is on the increase. The issue at hand, therefore, is not a theoretical one between free trade and protectionism. It is how, first, to prevent an escalating series of import barriers and subsidies, with countries retaliating against, or

emulating, one another and, second, to roll back the trade distortions imposed in recent years. In the current environment it is necessary that each nation resist the temptation to erect an economic Maginot Line around itself and be equally vigilent in demanding that others resist with similar strength.

At the same time governments are likely to pay a key supportive role (the subsidies for research and development, investment credits, encouragement of rationalization of production, training programs) for important sectors. A key question, therefore, is how to ensure that when such support is forthcoming it does not distort trade and investment. For instance, what constitutes legitimate government support for research and development, and when does support become a distortion of trade? When does a government incentive to attract investment, or improvements in tax treatment for investors, distort investment and trade flows? Clearly, at some point, a "modus vivendi" will need to be worked out among governments on these supportive efforts — or what has come to be known as industrial policy. Explicit understandings will need to be reached as to the type and degree of support which is appropriate — and perhaps should be encouraged — and what is distortive.

And assuming government intervention from time to time to protect sensitive sectors, for instance under safeguard arrangements mentioned above, what level and length of protection is appropriate, how can the protected sector be encouraged to adjust in order to be able to meet competition when protection ends or if it cannot ultimately compete, to shift capacity to more productive sectors gradually enough to avoid serious social and economic dislocations? In the latter circumstance, far more work is required to design programs that genuinely help workers and firms displaced by international competition and localities which suffer as well.

Conclusion

I conclude this statement as I began. The international economy is in a precarious state. It will not recover overnight. It can however benefit from a series of steps

to achieve sustained growth within economies and improve the international financial and trading systems. The world economy in the 1970's came through an extremely difficult period. But the early part of the 1980's will present it, and those nations which comprise it, with an even more difficult task. The worse the situation becomes, the greater the risk of serious, perhaps permanent, damage to the international economic system and to economies, such as ours, which increasingly depend upon it. Many Americans have now come to understand that growth in the U.S. is intimately tied up with that of the world economy and that the developing nations, which only a decade ago were not major factors in the world economy, today are extremely important to its well being.

If we are to seriously address the problems before the world economy there must be a genuine act of American leadership. This involves neither a requirement that we carry the burden alone nor the wrongheaded notion that we can impose our will on others — in both of which we would not succeed — but leadership in forging an international concensus on a strategy for improving the ability of the world economy to serve common interests. Our success may well be the key factor in determining whether the 1980's is a decade of prosperity or one of very slow growth, and great social and political instability.

Representative HAMILTON. Thank you very much, Mr. Hormats.

Let me begin on this question of coordination of policies. Mr. Meiselman took a view that surprised me a little bit. I haven't heard that discussed quite in your terms for a while. I think you said, if I heard you correctly, that there was no basis for believing that coordination of policies could work at all.

Mr. MEISELMAN. No reasonable basis.

Representative HAMILTON. And no evidence of success of coordination.

Mr. MEISELMAN. That's right.

Representative HAMILTON. Now that really runs counter to most of the comments you hear about the need for greater coordination of the seven countries in policies.

So I'd like, Mr. Miller and Mr. Hormats, for you to take off if you would on Mr. Meiselman's comment, and then we'll give Mr. Meiselman an opportunity to comment on what you have to say. How do you respond to Mr. Meiselman's observation, Mr. Miller?

Mr. MILLER. Mr. Vice Chairman, I would start off by saying the opposite of coordination, is complete isolation. If we wanted to draw a world where no one ever talked with anyone, no one knew policies of other countries, no one coordinated anything—I suppose the professor's theory would be the world would work very well.

I don't think so. I don't believe it would. And we have institutionalized our coordination in so many ways that cannot and should not be reversed. The OECD is a form of international coordination. I do not believe it's in any of our interests to abandon that agency. The IMF is a multinational institution that coordinates certain activities that would be very difficult to do on an individual or bilateral basis. One can go down the whole list of institutions that have been created and then one can look at one's own experience in government. In the days of the energy crisis, the decision was to coordinate—to see how we could deal with an oil shortage, and how we could respond to a boycott or a shutdown. It was essential then that we anticipate and coordinate our activities so that we did not destroy the world, destroy ourselves, by very self-centered policies that ignored the impact upon other nations and upon the Western alliance itself.

I can't imagine that we could have an effective military alliance by saying that we will maintain our armies, navies, and air force but never talk to anyone, never have any command structure, or never have any coordination of how to respond to a threat. I think the same is true in economic trade, energy policy, all of the policies that are concerned at the summit.

Now whether or not it is necessary by coordination to have a finite, rigid system, I doubt. I doubt that one can coordinate everything. I think the political systems internally drive nations to respond to their own pressures in certain ways and no one suggests that coordination means dictation, nor does it mean that there could be agreement on everything.

But I would be rather shocked if we should suddenly go into a world which would be purely inward-looking, purely self-centered, and ignore everyone else and try to coordinate nothing.

Mr. HORMATS. I think the question really has to be broken down to what you want to coordinate and how well you think you can do it.

There are problems, and I think we know from experience in the mid-1970's when there was a big debate as to whether or not, if the Germans ran a larger budget deficit, that would stimulate the German economy or lead to inflationary expectations which would weaken German growth. So I think that by way of illustration we have to be relatively humble about the degree of expertise we have and the degree to which we offer advice to other governments when our own economy suffers from controversy over what the impact of our budget deficit is.

So it seems to me there are certain things that we can coordinate with a certain degree of assurance that that coordination will lead to positive results as in the energy area, and other things, for instance, trying to fine tune macroeconomic coordination where we really have not advanced economics to the fine art of being able to know exactly what the output is of a given economic input.

So there is a range or a spectrum that we have to look at. It strikes me, however, that in general, an attempt to have a more intimate dialog on the impact of various domestic economic policies on the world economy is a desirable thing and if only because leaders have to take into account the impact of what they do on others, because the economies of the other countries, their trading partners, have such a major impact on their own domestic economies. So it strikes me that having a process where you get a better sense of what the impact of your economy is on others in your interest is a highly desirable thing.

Representative HAMILTON. Let me interrupt you. Should you strive for modest coordinated macroeconomic policy expansion plans, for example? You've identified growth as the key point, sustainable, noninflationary growth. What kind of coordination of macroeconomic policy is it reasonable to expect nations to engage in now and how much would you advocate? Helmut Schmidt talks about a joint economic policy among the nations and so forth. How do you respond to that? I'd like Mr. Hormats and Mr. Miller to comment on that, and then I'll get back to you, Mr. Meiselman.

Mr. HORMATS. I think that there are two parts of that question. One is, there are certain things that can be done to coordinate policy to for example, avoid major misalinements in exchange rates which have a major domestic impact. I think, for instance, that the policy mix between monetary and fiscal policy is very important in terms of current U.S. interest rates. We have relied very heavily on monetary policy as an inflation fighter in this country and very little on tightening on fiscal policy, and Japan places less emphasis on monetary policy.

Mr. Meiselman made a point about the franc-dollar exchange rate. The one that bothers me more is the dollar-yen exchange rate, and that in part, not totally but in part, results from totally different mix of domestic monetary and fiscal policy. And it strikes me that there may be a valid subject there for greater coordination, not so much to change the direction in which the economy is going but to try to adjust the policy mix that you use to achieve your goals. That's one point.

I think there is a valid argument to be made for that type of discussion.

Second, on the question of broader macroeconomic objectives, it's very hard, for instance, for an economist to think that coordination can really make major changes, for instance, agree on locomotives—where one government leads others out of recession. That's very hard to do.

There is one valid element of coordination that would be useful. That is, we tend to overshoot and undershoot. The recession of the late 1970's and early 1980's resulted in part from the fact that virtually everyone took contractionary measures at the same time, either through tighter fiscal policy, tighter monetary policy or both. Everybody did it to try to wring out the inflation from their economies all at the same time, and there was a mutually reinforcing effect set off as a result of that.

Now it seems to me that if we all had a better sense of the reverberations that would be caused to the system by looking at these policies together, some countries might have been able to step on the brakes a little less hard recognizing that the collective impact of all this was so substantial.

I think on the growth side there are certain things that we can do to lower our deficit and that will stimulate other countries, for instance, to relax their monetary policies and, as a result, we may get a collective strengthening of the recovery. That's what sort of coordination I think is very desirable.

Mr. MILLER. Mr. Vice Chairman, let's take a specific example of coordination. When I was at the Federal Reserve—I think you are aware of this—there was a monthly meeting of the heads of principal central banks where there was a discussion in an effort to keep up to date on what each was doing and why, so that there would be the opportunity in establishing monetary policy for individual countries, to be aware of the environment in which such policy would be applied. Such meetings continue today. Just the communication itself creates a form of coordination, because one central banker, knowing what other countries are facing and planning to do, can avoid the overshooting that might result if he were operating in a vacuum. If he knows another nation is going to move in a certain direction, his own response may be improved by that knowledge. This is a form of coordination.

On November 1, 1978, we executed a very well coordinated monetary response to the then perceived dollar crisis. That involved taking monetary action in a number of countries at the same time for the same purpose—to stabilize currency exchange rates—and return stability and a chance to deal with inflation over the longer term by reestablishing confidence in the U.S. dollar—the principal reserve and trading currency of the world. And that action was backed up by marshalling resources to intervene in markets if necessary. The latter was a short-term undertaking. The primary objective for coordination of monetary policy at that time was to achieve a specific result, and I think those are very outstanding examples of effective, useful, and beneficial results that contribute to world stability and health rather than the reverse.

Representative HAMILTON. Mr. Meiselman.

Mr. MEISELMAN. First of all, I'd like to take a step back and mention briefly some of the points that were in my prepared statement and, second, I'd like to comment about the presumed connections between deficits and interest rates which I don't want to let pass unchallenged.

There seems to be an assumption that somehow again if we deal with this enormous aggregate called the deficit or the total budget that that number really means something in the sense that if you fiddle with it you can have a direct predictable effect on interest rates.

Now if that were true, then we ought to be able to look back historically and see some connection between interest rates and the size of the deficit. I testified before this committee a couple years ago, and I presented evidence to the effect that there is no connection. That seems surprising until you start to think about it, because the deficit itself is really the difference between tax receipts and expenditures. It makes an enormous difference if you try to change the deficit by changing expenditures or changing taxes. It makes an enormous difference which kind of expenditure you're talking about. It makes a still greater difference if you discuss explicitly what kind of taxes you're talking about. You cannot lump all taxes together even if it is easy to try to do so in some budget document or in this kind of discussion.

For example, you can increase taxes that fall on saving, which is a tendency of this Congress, and there will be less saving, and that will mean that interest rates end up higher. You could increase taxes that fall on capital investment. That would mean, because the rate of return on capital is lower, there's less borrowing, there's less capital formation, and interest rates would end up lower.

You have to look at the whole structure of taxes. You have to look at the specific measures that are taken to change the aggregates. You just cannot deal with the aggregates themselves. That is why, both as an analytical matter and as an empirical matter, there is no empirical connection between fiscal policy aggregates and either real or nominal interest rates, even though sometimes for a couple of months you may see something that seems to make them move together.

That's one of the reasons that trying to do something about our own fiscal policy problems—and those problems are very severe—because of the presumed effects that it will have on other countries, it seems to me is empty. There is nothing to be had. There isn't even a point of saying that we ought to hurt ourselves in order to make the other countries better off. There isn't any of that. So I think that the whole exercise is one of great illusion.

If in fact there's something that could be done about U.S. fiscal policy, I would like to see those numbers. You would have to vote on particular taxes, on changing the budget. What is the tradeoff between what and what? I have never seen any of that. As far as I'm concerned, it's just a lot of empty talk. There's no way that you can engineer it because there's no analytical or empirical basis for achieving this.

So in some respects, as far as I'm concerned, we can stop the discussion right at that point. There's no way to do it, even if in fact we had a fixed rate world. Now we have a floating rate world, more or less, and

one of the functions in the changes in the exchange rates is precisely to take into account differences in inflation rates and differences in interest rates. That's one of the reasons the dollar is strong, and is one of the reasons that some foreign countries want us to intervene in order for us to inflate so it would make it easier for them to inflate. Any country can have as high or low a rate of interest as its policy leads it to without having any severe problems.

Mr. Hormats said that Japan followed a policy that was quite different from ours. Obviously they have because they've had such sustained growth. But I would remind you that Japan has had continued high budget deficits as a proportion of their GNP, and I would also remind you that Japan has for some years, for almost a decade now, pursued the kind of monetary policy that I have recommended to this committee, which is a policy of slow and steady money growth. So in Japan interest rates are low and they remain low. In Japan, people's savings are not taxed out of existence as we attempt to do in the United States, and Japan does not have the Keynesian disease which taught a whole generation of their economists that savings were evil and that are a leakage out of the system and something that ought to be discouraged. The savings rate in Japan is enormously high and that is one of the bases that has fueled the high rate of Japanese growth.

I think we ought to take some lessons from Japan and they are not quite the lessons that are sometimes drawn before this committee.

I would also say that in terms of exchange rate intervention, I find it very hard to understand people who say that the dollar is too high or too low. Compared to what? Central banks have a very poor record in terms of intervention in foreign exchange in the sense that they buy exchange when the rate is low and they sell it when it's high. That is precisely what a speculator would want to do, buy low and sell high. So if in fact central banks or treasuries were smart enough or had the right incentive to understand when their rates were temporarily low or temporarily high, their exchange rate intervention would result in profits to the central bank and that would be no different than any other speculator. The record is that central banks are sitting ducks. They lose their taxpayers' money year in and year out which is one of the reasons that a lot of foreign exchange traders are delighted to trade against the central banks. They stick it to them almost every time.

I repeat, if any American thinks that the dollar is too high, let him put his money where his judgment is and sell the dollar short. That exchange market has become highly democratized since the opening of the IMM at the Chicago Mercantile Exchange. You don't have to be a fancy banker in order to do that. It's open to all of us.

Representative HAMILTON. Congresswoman Snowe has to leave here in a few minutes so I want to give her an opportunity to ask questions and then we'll give you an opportunity to come back later, Mr. Hormats.

Representative SNOWE. I'm sorry to interrupt the momentum here. Thank you, Mr. Vice Chairman. I'll just ask a few quick questions because I do have a speaking engagement.

First of all, Mr. Hormats, you addressed the risks involved in the summit and what they may or may not be. What is your assessment

of the risk of this summit, and will, in fact, the United States be used as a scapegoat in terms of high interest rates and because of the fact that we have high deficits?

Mr. HORMATS. The risk of this summit is that there is a general feeling among most of the participants that they should not try to press one another so hard, as at Versailles, with very negative results. There is an attempt to downplay differences and not try to reach agreement on paper which is not there in substance.

The risk I think is that they simply won't do enough. The world is looking to Williamsburg for a substantial measure of leadership, not panaceas, not dramatic results, but leadership in establishing a sense of direction for the world economy and trying to develop a broad strategy that deals with the growth, trade, and debt questions.

My concern is that because of the informality and the lack of focus, the results will be ambiguous and the clarity of direction which is needed to insure followup won't be there. I think the administration has learned and others have learned a lot of lessons from the past and I commend that. I hope that they don't bend so far over backward that they don't achieve as much as they should.

Representative SNOWE. To follow up on the submit, I understand that there will be no preset communique to avoid controversy and to allow for flexibility. Is that an advantage or a disadvantage? Does that involve the likelihood of controversy?

Mr. HORMATS. It involves a potential for ambiguity—that's the problem. It can lead to controversy, if in a meeting with heads of state they discuss an issue and then one says that the result was x and another says it was y. it could lead to controversy. But in this environment, I agree with the notion of not having a communique. I think that the communique process has been too much of a preoccupation in the past, and it's a healthy experiment for one summit not to have a communique and see how it works.

I think, however, that there needs to be some way of recording where real agreement is reached so it's not like a tree falling in the forest with no one there to hear it. Someone has to hear the result in order to implement it.

Representative SNOWE. Mr. Meiselman, there's been discussion in recent days and weeks about having a global conference on exchange rates. Would you think that that would be something that would be to the international community's advantage?

Mr. MEISELMAN. No, not at all. There's nothing good that could come of it. A country that wants to strengthen its exchange rates can do so by lowering its inflation and putting its own house in order.

The last time we set up that system in the middle of World War II, the world was different. The United States was the only major country that was not in very bad shape. The whole world looked to the dollar because the dollar was the only currency that mattered. But even under those initial circumstances, the IMF Bretton Woods system eroded through the years. The fixed rate system started to fall apart. The fixed price for gold meant that as circumstances changed, even in a relatively noninflationary world, the United States lost half of its gold stock within 10 years. Things change through time and that's turned out that, in my judgment, that the IMF and the Bretton

Woods system itself became an engine of inflation because it made it possible for countries to inflate knowing that they would get bailed out. In fact there was a positive intent to inflate because you could get cheap loans from the IMF, and that's much the same set of incentives that the IMF and the World Bank still present to countries who get themselves in trouble. That's one of the reasons I would hope the Congress would look much more closely at what in fact the IMF and the World Bank does and not their claims to great success or their pleas to help the poor people.

I don't see any important purpose in an international meeting like that. What countries ought to do is as I've suggested before. I'm not against—let me not give you the impression—I am not against cooperation. I am not against communication. But there's no point in trying to cooperate and communicate to set up mechanisms that don't work or mechanisms that work against the best interest of the United States.

Mr. HORMATS. At this point in a conference would probably not be desirable, because there are so many differences in philosophy at this point that a conference would probably raise expectations well above what could be fulfilled.

I do think there is a need for a smaller group of countries—for instance the expanded Group of Ten—to take a look at the lessons we've learned from floating exchange rates over the last decade. We've learned a lot. The Bretton Woods system fell of its own weight. It led, toward the end, to a major financial crisis, a currency crisis, and a whole series of problems. It couldn't have lasted. We had high hopes that the floating rate system would lead to very smooth adjustment. In some cases it has. Certainly it was better than the rigidity of Bretton Woods, but it has also permitted, or at least not corrected, overshooting and misalinements.

One point I just have to comment on and that is the point Mr. Meiselman said that if Americans think the dollar is overvalued let them buy other currencies and speculate. There are a lot of workers out there and a lot of farmers who don't have the ability to make that sort of speculation. Their jobs are hurt by the overvalued dollar and to glibly say that the financial markets hedge against that—you go to Caterpillar, you go to farming communities, you go everywhere in this country, and you will find people whose jobs are affected by the exchange rate who don't have dollars to buy francs with or marks with or yen with. The Government of the United States in developing its policy on these issues has a responsibility to try to find ways of avoiding misalinements in exchange rates which have a devastating impact on a lot of sectors in the American economy.

I believe—and I think virtually everyone who looks at the trade implications of exchange rates believes—that it is distorting the American economy and distorting American trade. I don't have any magic answers. I agree totally that you cannot have a massive intervention policy which brings down the rate of the dollar. The dollar is high because real interest rates in the United States are very high. I won't go into it because we don't have the time, but there are a lot of reasons why they're high, but in part it's because people think that when there is growth in this economy there is going to be a very massive competition between the Government and the private sector for money and that is going to have an impact on future rates of inflation and future

rates of interest. And you go anywhere—people are making these decisions in New York or Frankfurt or anywhere around the world—it may be that there is some theory that says budget deficits do not account for high interest rates, but I can assure you that the people who are making these decisions, as to what price they want to sell their money for, sure as heck believe that that is one reason that rates are high.

Mr. MEISELMAN. I think I'd like to comment on that. The exchange rate and interest rates don't affect the economy uniformly. It affects different sectors differently. Now I don't think it does us any good to be myopic about it because the balance of payments balances. So we not only have to look at some sectors that may seem to be hurt by the exchange rate, we also have to look at those sectors that are helped by the capital inflow. So that if you have an industry that competes with imports, if imports are high, then it would seem as if it would be better if we could cut off those imports. It would help that industry. By the same token, it also means that foreigners have fewer dollars to buy other goods. They also have fewer dollars to invest in the United States. So that if we import Japanese cars, looking at it from the very narrow perspective, it hurts some of the auto workers in Detroit, but if we cut that out it means that there will be less capital imports in the United States and it would also mean that the housing industry would be adversely affected because interest rates would be higher.

So it's very cruel but it's an inevitable part of a market system that sometimes there's a tradeoff of one industry for another and the tradeoff of one job for another, and that is precisely one of the reasons that we need a growing economy with a great deal of internal flexibility to permit the other jobs to be had and to permit the reallocation of resources. We have moved in exactly the opposite direction in this country in recent years, to rigidify the economy, to give people incentives to stay put, to give capital an incentive to stay put, and not to have the mobility of human and capital resources that make possible not adjustments, not only the changes abroad, but internally. So it's true the exchange rate affects different sectors, but we have to look at the whole picture.

Mr. HORMATS. It's quite right that capital has not been mobile. What is the greatest deterrent to investment today is high interest rates. That's one reason why capital is not going into areas where it could be productive because there are people who go into Treasury notes rather than into productive investment because they can get such a nice high real rate of return.

Mr. MEISELMAN. Let the Congress authorize an increase in the ceiling on IRA's and we'll see more interest rates coming down. Let the Congress mandate that the Federal Reserve cannot increase the money supply at 10 to 15 percent, as it has been doing, and the interest rates will come down some more.

Mr. HORMATS. I would point out that when the Fed increased the rate of money growth, interest rates went down, the short rates went down.

Representative HAMILTON. Congressman Hawkins.

Representative HAWKINS. Well, I think the differences among the three witnesses illustrate the problem of having this summit, it would seem to me.

Mr. HORMATS. We can't even agree here you mean.

Representative HAWKINS. I doubt seriously if the President is going to be saying the same things at the summit that have widespread support from the American people, and I think it just illustrates that we've got to get our own house in order if we intend to make these summits productive and talk about the things that we should be talking about.

A few weeks ago the OECD countries met and declared that unemployment is a major problem facing the developed nations of the world. Here we're going to meet in a summit and talk about exchange rates and a lot of other symptoms of the recession and not even touch the major problem that was declared by this and other countries a few weeks ago to be the subject that should be on the agenda.

I think all of the witnesses have been very convincing, although I have great differences with some of them. Let me try to ask a few questions, however.

You keep using the phrase noninflationary growth rate without defining it, and it's being used by the administration as if there is some conflict in having a vigorous growth rate and meeting the problems of inflation.

I would like to ask, first of all, the witnesses just what is supposed to be a noninflationary growth rate? The Department of Commerce before this committee has changed the growth rate officially three times in the last month. It came before this committee 1 month ago and said that we were in a great recovery because we were growing in excess of 4 percent. Then a couple weeks after that they reduced it to 3.1 and now they have it under 3, which means that they can't get together on what the growth rate really is.

Assuming that it's under 3, is that supposed to be a noninflationary growth rate? It's certainly noninflationary, but is that the type of growth rate that historically and theoretically would put people back to work and would activate idle plants and so forth? I would like to ask both the witnesses, Mr. Meiselman and Mr. Hormats, what type of growth rate would be considered reasonably adequate in order to have a real recovery—and I'm talking about a real recovery, not a technical one— that would sustain the type of production that would not only employ the unemployed but also meet the problem of those who come into the labor market monthly as well and also take advantage of the rather high productivity rate which we now have.

Mr. Meiselman, perhaps you would give us some explanation.

Mr. MEISELMAN. I believe the evidence is that there's no shortrun connection between inflation and growth rate or between inflation and the unemployment rate. You can have growth when prices are rising or when prices are stable, and we now have the best of both worlds in the sense that we're coming out of a recession and we have growth and we have stable prices. There is a longrun tradeoff, though, because the higher the inflation rate——

Representative HAWKINS. Longrun tradeoff between what?

Mr. MEISELMAN. Between inflation and growth in the sense that inflation impairs the efficiency of the economy and because it impairs the efficiency of the economy there's less output, there are fewer jobs. So that over the longer pull, the higher the inflation rate, the higher the unemployment rate, although sometimes in the short run you can

buy off a reduction in the unemployment with having a little more inflation which is something that this country and other countries have tried to do over the last generation. It's one of the reasons that the whole world suffers from the problem of inflation, to try to use the printing press to paper over some of the problems of unemployment that are caused by poor public policy.

So for now, I know that's a complex professorial answer to your simple question, but——

Representative HAWKINS. Well, my question was, what growth rate do you think would be reasonably adequate in order to have a real recovery?

Mr. MEISELMAN. I don't think the growth rate is anything we can control directly. It's a result of a whole complex of factors, some of which——

Representative HAWKINS. Well, whether we can control it or not, what do you think the resulting growth rate should be to adequately put people to work and to——

Mr. MEISELMAN. I'd love to have an enormous growth rate. I don't see what we can do to directly affect the growth rate except that it's a byproduct of other policy. We run the great risk of trying to——

Representative HAWKINS. You don't think reduced interest rates would improve the growth rate?

Mr. MEISELMAN. It's a question of how you get the reduced interest rates. We don't twirl a dial and get reduced interest rates.

Representative HAWKINS. You say the legislature should legislate on the money growth rate and now you say that they should not have anything to do with interest rates.

Mr. MEISELMAN. On the money supply. But that's a separate matter from legislating on interest rates. If you ask me about the effect of a particular policy which happens to lower interest rates and then also has some other effect, then perhaps I can answer your question.

Representative HAWKINS. Well, let me ask you then more directly. I'll rephrase it to accommodate whatever views you'd like to have expressed. Do you think a negative growth rate such as we had between 1981 and 1982 would promote the growth that would improve the unemployment situation?

Mr. MEISELMAN. Obviously that was a bad time both for the size of the pie and for the total employment. That was a very sad episode in this country's history.

Representative HAWKINS. Well, you give a comment on it but you still have not answered whether or not the growth rate has anything to do with the unemployment rate.

Mr. MEISELMAN. Well, if we go from one growth rate to a slower growth rate, then transitionally the unemployment rate could go up; but you could have high unemployment and fast growth. You could have faster growth with less unemployment, but I'm not sure where you want to lead me.

Representative HAWKINS. I'm not trying to lead you.

Mr. MEISELMAN. I'm not trying to avoid you, but if we have faster growth, then usually we have lower unemployment.

Representative HAWKINS. Well, you used the phrase noninflationary growth rate. That's a phrase you used. Now I am only asking you to explain what is a noninflationary growth rate.

Mr. MEISELMAN. I'm not sure where in my testimony you're pointing to. If you have a noninflationary growth rate of money, then I could discuss that.

Representative HAWKINS. Mr. Hormats, would you care to comment on the question?

Mr. HORMATS. For the next couple years I think we could have 4.5 to 5 percent rate of growth without raising serious inflationary problems—for two reasons. One, assuming the right things are done, you could have a higher rate of growth because we have very low level of capacity utilization today and I think if we got 4.5 or 5 percent growth for a couple of years we would probably not in general run up against major supply constraints and major production constraints.

Now the question on unemployment is slightly different because how many jobs are added will depend in part on the view of private employers as to how long that recovery is going to last. I think that private employers, if they think it's going to be a short-lived recovery, will be reluctant to hire many new people because they will want to improve their balance sheets and they won't want to make major new hiring commitments.

So that you could have a relatively robust rate of growth for a period of time without getting a major boost in job creation.

Now what happens after that—phase 2 will depend in part on new capital accumulation. In other words, is the private sector going to conclude that there's a good possibility of a long recovery and strengthen that recovery by a lot of new capital spending? That's the thing that's in doubt today. That's why interest rates are high, because there is a two-fold concern; one, that the economy will grow for a period of time and then sort of flatten out; and, two, they inhibit capital for the next couple years and added capital spending and a longer spending. It strikes me that if you get a reasonable rate of growth probability of recovery, then you'll get a lot more employment. There will still be structural problems but you will get a lot more employment and you'll get also capital spending.

So for the next couple years I think you could reasonably get a 4.5-percent growth without major inflationary problems. What happens after that will depend on whether new capacity is added to the economy.

Representative HAWKINS. So do you construe the current growth rate, which is by admission under 3 percent, adequate to affect the unemployment rate to any appreciable extent?

Mr. HORMATS. No, it won't have very much effect in the near term on the unemployment rate.

Representative HAWKINS. Thank you.

Thank you, Mr. Vice Chairman.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Vice Chairman.

I have enjoyed the testimony very, very much. It's been very stimulating. I have two questions, Mr. Vice Chairman, so when you think I've gotten through half my time you send up the early warning signal.

It seems to me that what everybody is saying is that we're really not in a condition to deal very effectively with economic problems

both within our country and between countries. Bob Hormats has talked about overshooting and undershooting the mark. Professor Meiselman has talked about the difficulty of coordinating programs between countries.

I know something about the structure of the Japanese economy. I had the pleasure of going to Japan with Bob Hormats, and we had the somewhat dubious pleasure of watching robotization at work at the Yamasaki plant and it was fascinating but it was fearsome too to try and think where that could lead us and the kind of structural problems it was going to lead us into.

I think in defining our industrial policy we're going to have a great deal of trouble convincing the Japanese not to continue the policy of MITI, their ministry of international trade and industry that has served them so well. They've been supporting winners and helping the losers phase out, and they say that we have given a higher percentage of government support to research and development in this country than they have, only it's been mostly in defense rather than the private sector. So these are very challenging structural problems.

To get to my question or to get closer to my question, I remember with what excitement in the late 1930's when I was a college student studying economics at Swarthmore College, I read the work and the final report of the Temporary Joint Economic Commission, the TNEC, and I can still remember that great big white book with blue letters, "SAE," the Structure of the American Economy.

Have we gotten to the point of confusion and irrationality and incapability of coping with problems in our own country as well as problems between our country and other countries where we really need to have to pay some attention to basic structural problems in our own country and global problems, problems of global competition.

If you want to get an example of that real fast, just look at all of the calls on the part of enlightened experts like yourselves for lessening of tariff barriers and protectionism while at the same time there's a strident push in the Congress for more protectionism.

Would a basic study of the structure of the global economy help us sort out some of the problems and help us create the common economic language whereby we could reach comity internationally and perhaps put our own domestic house in better order?

Mr. MEISELMAN. I think these studies go on all the time. I don't see any special merit in having still another global study. The only merit I see is it would increase the demand for economists and I'm always biased in that direction, but beyond that bit of self-interest, I don't see that there's anything special about this particular year or this particular set of circumstances.

These matters are subject to ongoing studies and ongoing discussion all the time and that's one of the functions of this Congress and of this government and communication among governments, including communication of various international agencies.

I'd like to ask you, if I can turn the tables, about the report of the TNEC which came out—and I have been told how they were greeted. I started studying economics several years after that. I know they were very informative and they had some very path-breaking technical studies and what not, but in terms of their actual impact on economic

policy in the United States, even though those were very difficult years, I think that in general the impact was quite limited. They were informative, to be sure, but I don't think they gave very much direction in general to public policy.

Representative SCHEUER. Well, in deference to Gardner Meads who was the director of that study in his very youthful years and who is still around today and very healthy and very brilliant still, I would say that that study did provide economic grist for the mill and did provide economic stimulus, and it was very thought provoking for a whole young group of economists who populated the New Deal, the Keynesian economists to be sure. Maybe today we'd say they did a lot of things right, but they may have done a few things wrong. I don't say that everything that came out of that study was right or the New Deal economists of the Keynesian stripe were all 100 percent correct. But I do think it had an influence on the thinking of the economists of the day who very soon after began to populate the Federal Government at the top levels.

Mr. Hormats.

Mr. HORMATS. Well, I think there is an equivalent type of exercise going on, perhaps not as ambitious as that, in the OECD where there has been a good deal of work done on the question of structural adjustment. In other words, what are the new trends in the world, new directions of trade, what sorts of pressures are there of a structural character on economies. Over the last several months I have really lost track of how far that exercise has gone, but I think that it deals with the sort of issue that you've been raising, that is, what are the structural problems and how does one adjust to them in a smooth way.

I would think that, rather than set up a brand new study, although that might in the long run be desirable, it would be useful to take a look at the work done there in the OECD and see if that could be further developed.

I believe that that was high quality work and it may well be that the answer is to put more impetus behind it rather than set up a new group.

Representative SCHEUER. Now here's my second question, Mr. Vice Chairman. I'm making tremendous progress.

Representative HAMILTON. Take your time.

Representative SCHEUER. Talking about the OECD, there's no doubt that in developing world countries, the overriding problem that beggars all other problems to almost insignificance, is unemployment.

Mr. HORMATS. Absolutely.

Representative SCHEUER.. The World Bank and the ILO, the International Labor Organization, tells us by the year 2000 there will be a deficit over and above the current job deficit, over and above the current levels of unemployment and underemployment, of about 650 million jobs. Now that's more than the entire employed population of the developed world. There's no way on earth the developing countries are going to produce the kind of capital, no matter what level of foreign aid we project from the developed world, that is going to fuel this kind of job creation.

Mexico is going to have to produce 1 million jobs a year. Well, at the greatest rate of growth the United States has ever had we've only

produced 2 million jobs a year, and the Mexican economy is less than 10 percent of our economy. If you assume that it only costs $1,000 to produce a job—and in Egypt it costs $10,000—but let's be wildly optimistic—if it cost $1,000, that's $650 billion.

To think that that's going to be available in the next two decades would be wildly optimistic, but yet the developing countries seem not to be addressing themselves to the problem of employment. Every time they accrue some capital for development they don't put it into labor intensive economic enterprise that is job producing for their own people. They put it into capital intensive enterprise. The one thing that's scarce with these developing nations is capital. The one thing that is plentiful is labor. Yet they will almost invariably feed their preoccupation with capital intensive enterprises, thus doing little or nothing to help produce an answer to the overriding problem that faces their people, and that is jobs.

Is there something more that the OECD should be doing in terms of jawboning perhaps—after all, they represent the donor countries of the world. Should they be doing more in terms of not only jawboning the individuals of those countries, but doing more with the World Bank, with the regional development banks, to get them to get off this kick of almost exclusive preoccupation with capital intensive economic development in the Third World?

Mr. MEISELMAN. May I answer that?

Representative SCHEUER. I'd like to hear from both of you.

Mr. MEISELMAN. It seems to me that one of the reasons for that problem—and I agree with you it's a serious problem—is that those countries have a high degree of central direction by government planners, and that makes it possible to build these monuments to waste and folly, especially they aren't using their own money. That's quite different than a private businessman or private farmer trying to get ahead where the incentives are to economize on the use of capital and to make rational decisions as between labor and capital and other things. If you don't have——

Representative SCHEUER. I don't want to interrupt but I've got to. Why shouldn't we develop institutional mechanisms to prevent our money being used to subsidize, as you quite accurately say, waste and folly. In fact, your adjectives are charitable in the extreme.

Mr. MEISELMAN. Well, I'm before this mixed audience, so I try very hard.

Representative SCHEUER. Yes; there's a little bit of corruption and a little bit of nepotism.

Mr. MEISELMAN. I think the mechanism already exists and it's known as private property and the free market. There's no way that government-to-government grants can ever result in efficiency because people are not using their own assets. They're not using their own assets. They don't have either the information or the incentives to make efficient decisions. No way; you could have all the studies and all the fancy Ph. D.'s and all the institutes in the world making more studies, using more computers, and it doesn't affect the fundamental notion about the information and the incentives by the decisionmaker. And unless somebody is responsible for those assets, usually unless you're using your own money, you're going to do that sort of thing.

I would dispute the notion that it takes a certain amount of assets to make a job. Jobs just aren't created that way. And it's not as if x number of dollars gets you y number of jobs, so that if we transfer some of our wealth to other countries that would guarantee a certain number of jobs. That's not the way the economy works.

You have to have the correct incentives there and those incentives are typically given in the free market-private property context and that's the general point I cannot overemphasize, and I think that much of the effect of the government-to-government transfer of capital, particularly in the role of the multinational lending agencies, has been to set up systems that guarantee that kind of waste and the results have not been there and they cannot be there and it's not because techniques are not known. It's not the lack of knowledge. It's the wrong damn system.

Mr. HORMATS. Could I comment on that?

Representative SCHEUER. Certainly.

Mr. HORMATS. First, it has nothing to do with how centrally run the country is. You have some countries that have done very well in improving their agriculture with very strong central governments. South Korea is one. And in fact, China, with a very strong central government, has also—with a totally different system from Korea but a strong central government—devoted a lot of attention to the rural sector. So I don't think one can say it's a question of ideology or strength of central government.

I think the question of incentives is a very important point. I agree with that. The problem is that in many of these countries the incentive is not there, particularly for the rural sector. The incentive is not there because food prices have been suppressed to, in effect, subsidize the cities at the expense of the rural folk, and those farmers don't have the incentive to produce. They don't have the money to buy fertilizer, and in a lot of countries that has led them to have weakness in the sector that should in most of these countries be strongest.

I think in answer to your question, a number of countries, in some cases belatedly, but most have come to recognize that they have made mistakes in terms of the incentives they provide. India and Pakistan have devoted, for instance, a lot more attention to the rural sectors, and the rural sectors are doing much better as a result. And I agree that if you hold down the incentive to production, you will not get the production, no matter how much resources you put into it. I think that point is well taken.

That brings me to my last point. In some cases, it is tempting to say let these countries and these people use the assets they have. In many cases, however, they don't have assets. If you go into the rural areas of Mali or Senegal, they don't have any assets. They don't have assets to buy little handmade plows. They don't have the assets to buy fertilizer. They don't have the assets to buy seeds.

So it strikes me that the right combination is to provide the incentives to make sure the domestic policy of these countries are right. There's no point in putting lots of money into developing countries if the domestic incentives of the countries are all wrong. But, if the domestic incentives are right, then it strikes me that the World Bank and the others that have money are necessary—their funds are very valuable assets and very valuable tools for development. And I would go

further and say that there was a very recent World Bank report on Africa, which you may have read, done with the support of the World Bank, which made this very point. You've got to have the right production incentives. If you do, then the resources can be well used. I think that's the right combination.

Some of the big ticket, high capitalization projects in many of these countries have, as stated, simply not been well used. But I would say there are a number of countries that have used them quite well. Brazil, by and large, has invested in big ticket items and most of that—I won't say every project, but I would say most of that—has been used for the right sort of things. They built a big dam with a lot of international money. The dam was needed to reduce dependence on imported energy. Now I think that that needn't be exclusive—and it wasn't exclusive of the agricultural sector—but there are some areas where big ticket, high capital items are needed for a country's development, just as long as they fit into a sensible economic plan.

Representative SCHEUER. Thank you, Mr. Vice Chairman.

Mr. MEISELMAN. May I add a P.S.?

Representative SCHEUER. Please do.

Mr. MEISELMAN. For these kind of big ticket items, there's something called the international capital market which is already there in place. So I don't really see that it's necessary to have Government intervention.

Second, I would be very surprised if anybody from the World Bank is looking out for that poor little farmer in Mali.

Mr. HORMATS. Well, you'll have to go there and see, but I would say that it's very hard in developing countries to finance through international capital markets at 9.5 percent interest hospitals and roads and things of that nature.

Representative HAWKINS. May I make one comment?

Representative HAMILTON. Surely.

Representative HAWKINS. I don't know why we're talking about foreign countries. You can walk from El Paso to Juarez across the border. Those companies that we gave tax breaks to in 1981 are building plants across there. No. this is a so-called decentralized government which is engaging in waste and folly, if you want to call it that, because we're using taxpayers' money to subsidize production in another country just across the border to take advantage of their economy.

So it would seem to me we should address what is close at hand and what's happening in these big so-called incentives—the tax bill of 1981 was sold on the basis that it was going to create jobs. Well, it's creating jobs, but in this instance not for Americans. But down at Garfinckel's you'll get a bag to carry your purchases in, if you're able to trade at Garfinckel's, and on the bottom of it it says "Assembled in Mexico."

Representative SCHEUER. Well, there was a purpose in that. I mean, that was perceived as a way of helping provide some additional jobs in Mexico. After all, we can't tell the Mexicans we don't want your people; we want to close down illegal immigration to the maximum extent possible, and besides that, we don't want your product. We don't want the product of your labor.

I don't think the American public is willing to say that. So we are saying we have to control our borders. We have to regularize immigration. But while we can't provide jobs for every Mexican that wants

to come to the United States, we are going to help provide more jobs for Mexicans in Mexico, and that's the basic logic of that provision.

Representative HAWKINS. Well, we should say so and not give the impression to the American people by giving these tax handouts to certain groups that we're creating jobs. We should say we're doing it because of international comity, and that's what it's for, and if the American people want to support that, that's good, but you're not giving General Electric a tax handout in this country in order to produce goods and services in another country. That's not the purpose of the tax system. You should do it forthrightly it would seem to me and openly. That's the only point I'm making.

Representative SCHEUER. Let me ask one more question of Mr. Meiselman. Do you think the fact that the international private banking community knows that when they make a lot of wrong judgments they can rely on the fact that Uncle Sam or a few other countries are going to bail them out explains some of the really stupid loans that they've made?

Mr. MEISELMAN. No question about it.

Representative SCHEUER. How do we send them a signal that they've got to make loans that are based on economic merit?

Mr. MEISELMAN. Stop bailing them out and stop giving more money to the International Monetary Fund which is the initial bailout line because main of the major functions of the International Monetary Fund is really to underwrite these kinds of loans. The risks involved ought to be part of the evaluation of a commercial bank which would be a business deal. If in fact you want a special subsidy, it ought to be discussed as a specific subsidy and it ought to be voted explicitly by this Congress, not hidden in all of those complexities where the bill will not be delivered until later on and then we run the kind of brinksmanship that we've done now where it's very difficult to make a rational decision, but it seems to me that you're being called upon to throw good money after bad without changing the underlying system, and the underlying system gives a very strong incentive to both borrower and lender to make bad, wasteful loans that are burdensome to the American capital market and to the American taxpayers.

Now you may not be able to turn it off cold turkey, but at the very least you can change the incentives now. Now is the time to do it when the heat is on. If everything is calm, there's no incentive to do it. Now is the time to do it, and unless you change the provisions in a few years, you'll have to come back and vote still more money, and any foreign country that does not put itself in at least the appearance of jeopardy so it can then get cheap loans ought to have its finance minister fired. That's the incentives we've set up and I think those incentives ought to be changed.

Representative SCHEUER. Do you want to have equal time on that?

Mr. HORMATS. I think we're all against bailouts but I think one has to look at the role of the IMF in a somewhat different way.

If one looks at the history of IMF standby agreements, the history is that when the money is provided by the IMF it tends to lead to an increase, not a cutback—an increase in bank support for those countries to undertake their stabilization schemes.

Now this is not to say that every IMF agreement is perfect, and it is not to say that these are not helpful to the financial community in general. Indeed, they are. But I would go back to one of the points made earlier. If we pull out the pegs from under the system and as a result force enormous contractions of lending into the system, we are going to generate enormous political, social, and economic pressures in these countries. That will feed back in a very dramatic way on the American economy. We've got a tough problem here. We're not out of the woods on this.

As I pointed out in my testimony, we may only be in the eye of the hurricane on this debt issue, but there are a lot of things we can do, none of them by themselves satisfactory, but collectively, when added up, they can help to sustain the system without a major cutback in growth, which would have very serious implications for the world economy.

There are no perfect answers, but I think that a failure to provide support for the IMF would be an enormous abrogation of American leadership and would really throw an enormous monkey wrench into a system which is already facing some major problems.

Mr. MEISELMAN. If you support the IMF without changing the conditions, then you're saying everything is fine.

Mr. HORMATS. No; I'm saying that the IMF programs are, with the conditionality that is involved in them, attempting to change the conditions so that countries will be able to develop a more sustainable relationship between debt and capacity to manage the debt.

Mr. MEISELMAN. We've had years and years of experience with that and we see what the bottom line is. Unless you change the system, you're not going to change the results.

Mr. HORMATS. Some have worked and some haven't. Turkey has been a successful IMF stabilization plan. There are some you could point to that have not been successful.

Mr. MEISELMAN. There are very many and that's the problem.

Mr. HORMATS. All right. So the question is, the objective of the IMF is to try to get countries to stabilize their economies without major disruptions in growth. It has in some cases done well. It has learned a lot. I don't say that all these programs are totally sustainable. Some of them may need to be renegotiated, but I think that trying through this method, rather than completely abandoning the IMF and precipitating a major drop in LDC demand which would occur as a result, is even less the answer.

Representative HAMILTON. I usually tell the staff of the committee that I like to have witnesses with two different points of view so that we can get a discussion of the issues, and I want to say that staff has succeeded——

Representative SCHEUER. Beyond your wildest expectations. [Laughter.]

Representative HAMILTON [continuing]. Beyond my wildest expectations here this morning because I'm not sure we've found any issue you gentlemen agree upon today.

Let me ask a noneconomic question for just a moment here and maybe this is directed to you, Mr. Hormats, because of your State Department experience.

The question really is, how do you deal with Mr. Mitterrand at this summit? It seems to me that there's a very good chance that he's going to be quite isolated, with the United States, Germany, and the United Kingdom coming in with the general view that in the United States that the economic recovery is underway and it's going to be sustainable and the market is going to take care of the high interest rates and we're going to weather out the international debt crisis. That's going to be kind of the view I think that Williamsburg will express.

Mr. Mitterrand comes in with a very different point of view. Recovery is not going to be strong enough to lift the European countries at least out of their trouble. They really ought to have a coordinated policy of reflation, that you're going to have to give a lot more assist ance to developed countries and all of these items that I know you're very familiar with.

Now France, for all of the problems with the economy that they have, is still a very important part of the alliance, so I'm not in my own mind at least sure that it's a good idea to isolate Mr. Mitterrand here.

How do you respond to all that?

Mr. HORMATS. I very much share your view on that. I am not a great enthusiast for some of the elements of French policy that were originally pursued in the new French Government, but I do think that they have made some very positive changes in their economy which will strengthen the French economy over a period of time if they're given a chance to work.

The changes in policy which President Mitterrand and Finance Minister Delors have announced over the last month or two are important changes and constructive changes. The objective should be to give them time to work and to strengthen the French economy.

In general, Mr. Mitterrand's philosophy, and that of other countries, are quite different at this summit as you pointed out. It is not and has never been, in my judgment, a healthy objective of American policy to try to isolate the French.

The French have a different—traditionally in many cases a more dirigiste—point of view, much more intervention. They run their economy in a somewhat different way.

But I think the answer to that is to work with them to have a dialog with them, not to try to isolate them and try to put them into a box. That will simply lead to reactions in France and may make it more difficult for the French Government to pursue the sounder policy approach that they're now embarked on.

I go back to an interesting period in history. In 1971, after the measures that President Nixon took in August, there was debate within the U.S. Government. It was a question of what new exchange rate regime was to be substituted for the one that had fallen apart. The debate was whether to try to go around France and work on the Germans and the British and others and then say to the French, "We've worked out a deal with these other countries which we want you to accept," or go to the French first and try to work something out.

It was felt, I think by most people, including myself, that working with the French was by far the better course of action because to try to do it the other way and try to isolate them, would make it more difficult for them to come along in the final analysis. And there was a

possibility of weakening the European community by trying to play one member off against the other which is also, in my judgment, not a proper or healthy thing from the point of view of American interests.

So I think if one looks at the approach over time, over the last 10 or 15 years, it is not always easy to work with the French, as you doubtless know, but the preferable approach is to try to do that rather than put them in a corner.

Representative HAMILTON. One other question with regard to procedure of these summit meetings. Is it possible now to get under current circumstances an easy, informal, free exchange of views among the leaders, relaxed, so that they're not trying to win political points worldwide or have we gone beyond that point? I mean, have the summits gotten away from us in this sense that you lose the advantages that can flow from an easy exchange of views by world leaders?

Mr. HORMATS. I think it's still possible to capture the less confrontational approach of the earlier summits. I would just make one point about earlier summits. They were a little lower key than recently in terms of the public exposure they were given, but internally—there seems to be this romantic notion that has caught hold in some quarters that Mr. Rambouillet, which people point to as the best of the summits in one sense, was not a prepared summit.

Representative HAMILTON. Was that the first one?

Mr. HORMATS. That was the first one. In fact, one of the problems there was corrected subsequently which was that many leaders—not all but some—read their statements. There is also the notion that the monetary agreement which was worked out somehow sprung forth out of the summit in a sort of spontaneous combustion. In fact, that was worked out in great detail well in advance of the summit. The preparation was very intense, as is the case today, and the leaders in effect were more formal in terms of the way they approached these issues.

I think the real difference, if I were to pick one to focus on, is that there is a great tendency today for leaders to stake out their position publicly and in advance of summits. That creates a sort of win-lose atmosphere at the summits, when leader's going-into-position is compared to the final results and people tend to look, as they do at a football scoreboard, at which leader won what points over the other. I commend the administration for not, at this point, making public statements about the positions in the same way that has tended to be done in the past. I think that's a very positive plus.

Representative HAMILTON. It makes it very difficult to deal with President Mitterrand because he has staked out his position.

Mr. HORMATS. Yes, I know, and I think it's too bad, because if the leaders collectively were to avoid staking out these positions, it would be a less charged atmosphere internally, and you wouldn't have the after-summit comparison of winners and losers. That would be important. Most leaders have not said anything publicly.

Can I add one point on your previous question? That is about the French. It is particularly fortunate that Finance Minister Delors is chairman of the "Group of Ten" which is now looking at these financial trade issues, and I think that particularly in the case of someone as good and as responsible as Jacque Delors, giving France a role like this helps to keep them in the system in a constructive way.

Representative HAMILTON. Any other questions, gentlemen?

[No response.]

Representative HAMILTON. I really have dozens of other questions but you've been at it for a good long time and I think most of them probably have been at least touched upon if not in your responses to the questions in your responses to each other, and we're delighted we had both of you here for excellent testimony and we thank you for it.

The committee stands adjourned.

[Whereupon, at 11:35 a.m., the committee adjourned, subject to the call of the Chair.]

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